MAYER • BROWN

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Trustee Quarterly Review

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The new Code of Practice on incentive exercises

Regulator-approved but non-binding framework for incentive exercises comes into effect

Summary

A voluntary code of practice on incentive exercises (the **"Code"**) has been published. It is designed to ensure that exercises aimed at reducing pension schemes' liabilities by encouraging members to transfer out or to modify their benefits are undertaken in line with good practice principles.

Facts

The Code applies to exercises which encourage members to transfer their benefits to another scheme (**"transfer exercises"**). It also applies to exercises which encourage scheme beneficiaries to modify their benefits in some way, usually by giving up their right to annual pension increases above the statutory minimum (**"modification exercises"**).

Exercises of both these types are called "incentive exercises", whether or not the member is offered a cash incentive for agreeing to the transfer or modification. The Code applies even if the exercise just involves promoting an existing option or offering to pay for independent financial advice. However it is not intended to apply to a new option which is available to everybody as a matter of course.

The Code sets out the following seven principles which it says should be followed in any incentive exercise:

- No cash incentives may be offered if they are contingent on the member deciding to accept the offer to transfer or modify their benefits.
- Members should be provided with impartial financial advice or guidance, depending on the nature of the offer being made to them.
- Member communications should be fair, clear, unbiased and straightforward.
- The parties involved in an incentive exercise should maintain records.
- Members should be given sufficient time to make their decision without undue pressure being applied.
- Incentive exercises should only be offered to members aged over 80 who expressly request that the offer be made to them. When financial advice is being provided, a policy should be in place to protect members who are vulnerable by reason of, for example, their age, health or understanding.
- All parties involved in an incentive exercise should be aware of their roles and responsibilities and should act in good faith.

Members will have to be given figures showing the amount of the saving the sponsor/scheme expects to make as a result of the exercise. This approach seems likely to be a significant deterrent to many members.

The Code does not override or replace existing legal requirements or guidance (including the Regulator's guidance on incentive exercises). The Regulator supports the Code, and has reviewed and significantly shortened its own guidance. Its revised guidance continues to state that trustees should start from the position that an incentive exercise is not in members' interests.

The Code is accompanied by a set of practitioners' notes, which are designed to be used in conjunction with the Code, but do not have to be followed in order to comply with the Code.

Although the Code does not have the force of law, it is clear that both its authors and the Government expect future incentive exercises to be conducted in compliance with its provisions. The Pensions Ombudsman has indicated that he will take the Code into account when he considers complaints by scheme members about incentive exercises which begin after the Code came into effect.

Comment

The Code seems well designed to reduce take-up in such exercises, so that they are taken up only by the possibly small number of members who make an informed choice that it will be in their interests. Rather than reducing the number of incentive exercises, the Code may increase them as there is now effectively a blueprint for how sponsors should go about liability management.

The Code does not impose any additional duties on trustees, and it expressly acknowledges that following the Code is not a legal duty of trustees. From that perspective, the introduction of the Code does not make it any more or less acceptable for trustees to participate in an incentive exercise. Trustees will still need to assess whether to participate in accordance with their usual trust law duties.

However, the Code clearly envisages that trustees may choose not to participate in an incentive exercise which does not comply with the Code. Trustees will therefore now need to consider the Code, and the extent to which an incentive exercise in which they are being asked to participate complies with the Code.

Anna Rogers

Proposed new rules on bulk transfers and changing contracted-out rights

Bulk transfers will become easier but changing contracted-out rights may become harder

Summary

The Department for Work and Pensions (the **"DWP"**) has issued a consultation on draft regulations which correct some mistakes in the legislation about bulk transfers and about amending contracted-out schemes. The regulations are intended to come into force on 6 April 2013.

Amending contracted-out schemes

Where the rules of a scheme holding s9(2B) rights (i.e. defined benefit rights earned in contracted-out employment after 5 April 1997) are being changed, under current legislation the actuary must confirm that scheme benefits will continue to satisfy a statutory "reference scheme test" (**"RST"**). However, the current legislation does not hang together well: strictly it is only a change to s9(2B) rights that have already built up which triggers this obligation, and yet the confirmation that the actuary has to give relates to benefits which are to build up in future. The consultation therefore proposes the following changes:

- The actuary's confirmation will only be required in respect of changes affecting future service benefits.
- As regards s9(2B) rights which have already built up, schemes will not be able to make:
  - any changes which reduce the current level of a pension in payment or which convert defined benefit rights into money purchase rights;
  - any detrimental changes unless the actuary certifies that the change would have little effect on the overall value of the pension benefits provided (the "actuarial equivalence test"); or
  - any changes which do not leave the scheme providing for a survivor's benefit equal to 50% of the member's pension.

Bulk transfers without member consent

Currently legislation imposes various restrictions where a scheme wants to make a bulk transfer without member consent. The proposed changes would relax some of these restrictions:

- It will be possible to make bulk transfers of members' built-up contracted-out rights without their consent into a scheme which has been contracted-out, but no longer is.
- It will also be possible to make bulk transfers of members' built-up rights (whether or not these include contracted-out rights) without member consent on the basis that both schemes relate to employment with the same employer, even if the employer in question no longer employs active members of the receiving scheme.
- It will also be possible to make bulk transfers of built-up rights to some non-UK pension schemes in the European Economic Area without member consent.

Comment

The changes to the requirements for bulk transfers are welcome as they remove unnecessary restrictions. Similarly, no-one will be surprised by the clarification that it is future service benefit changes in contracted-out schemes that require an actuarial confirmation about future benefit provision; this will only bring the law into line with the way people expected it to be read anyway.

However, the proposed new requirements for changes to built-up s9(2B) rights seem more restrictive than is appropriate. Contracting-out legislation does not actually require schemes to provide a survivor's pension which is 50% of the member's pension. Many contracted-out schemes do not. If such a scheme cannot amend built-up s9(2B) rights in any way – even by making a clear-cut benefit improvement – unless it is also amended so as to provide 50% survivors' pensions, very likely the employer will just decide not to make the benefit improvement it originally had in mind after all. It is hard to see why the DWP has proposed this new restriction. We will respond to the consultation along these lines and hope that the final regulations will apply a more appropriate test.

Beth Brown

This article is based on a bulletin previously published in PLC Magazine.

Capping pensionable pay increases by contractual agreement

Courts uphold the validity of a pensionable pay cap achieved by contractual agreement rather than scheme amendment

Summary

The High Court has held that a cap on pensionable pay was valid even though it had been achieved by a contractual agreement with the employees rather than by amending the scheme rules.

Background

Where an employer wishes to change the terms of members' benefits under an occupational pension scheme, it can do this either by amending the scheme rules (which will generally require the consent of the trustees) or by entering into a contractual agreement with the members whose benefits will be affected. While case law has upheld the validity of amendments made by contractual agreement, the precise scope of an employer's ability to change pension benefits in this way is by no means clear.

Facts

Mr Bradbury was a member of the BBC Pension Scheme. The BBC decided that, in order to reduce the scheme's deficit, it would limit the extent to which future pay increases would be pensionable. Among the options put to the members was continued defined benefit accrual with a 1% cap on future pensionable pay increases. Where members chose this option, the cap on pensionable pay was achieved via a contractual agreement whereby pay increases were conditional upon the member agreeing that only the first 1% would be pensionable.

Mr Bradbury unsuccessfully complained to the Pensions Ombudsman and then appealed to the High Court.

Decision

The court held that, provided the member gave informed consent, contractual acceptance of a pay award on the prescribed terms would be binding on the member concerned unless the employer had breached its implied duties of trust and confidence and good faith towards its employees.

Comment

From a trustee perspective, this case is important as it confirms that at least some changes to pension benefits that would usually require an amendment to the scheme rules can be made by contractual agreement. However, the decision does not give employers freedom to make any changes they wish by contractual agreement: the members must give informed consent, and any use of a contractual agreement will be subject to the employer's implied duties of trust and confidence and good faith.

Richard Evans

The way forward for small DC pension pots?

Small DC pension pots to automatically follow employees from job to job

Summary

The Government has set out how it plans to tackle the multitude of small DC pension pots that will result from the introduction of automatic enrolment.

Background

At the end of last year the Government issued a consultation document on how to deal with small DC pension pots. Three approaches were suggested: (1) make it easier to transfer small pots; (2) automatically move small pots to an "aggregator" scheme when individuals move jobs; and (3) automatically move small pension pots with individuals as they move from job to job.

Consultation response

Most respondents to the consultation supported the aggregator approach, but research by the Association of British Insurers indicated that consumers preferred the third option. The Government has therefore decided to adopt this option. The Government recognises that this is an ambitious reform and will now explore with industry stakeholders how the proposed automatic transfer system should work.

The Government has also confirmed that it will be abolishing short service refunds from DC schemes at the earliest legislative opportunity. However, it is investigating the merits of allowing DC schemes to refund pots which are so small that they are not worth transferring.

Comment

Whilst the Government's chosen option should reduce the number of small pots, it remains to be seen how the Government intends to tackle the valid concerns about this option that were raised in responses to the consultation such as differences in fees between the transferor and transferee schemes and what happens where the new employer's scheme is a defined benefit scheme. The interaction of automatic transfers with scheme rules which require trustee consent for transfers-in and transfers-out will also need to be considered.

The Government has said that they want to achieve the changes as soon as practicable, but we think that the new system is unlikely to take effect before 2015/2016.

Olivia Mylles

Abolition of protected rights: short service refunds

Easement for schemes whose rules prohibit refunds of protected rights

Summary

New regulations allow schemes which were previously contracted-out on the protected rights basis to continue paying short service refund lump sums where their rules mean they cannot include protected rights in the refund.

Background

As we reported in our February edition, from 6 April 2012 contracting-out on the protected rights basis was abolished. As a result, protected rights ceased to be subject to special treatment under legislation.

However, schemes that were contracted-out on the protected rights basis had to include provisions that reflected the old statutory requirements in their rules. Those rules do not automatically fall away just because the old legislation has been repealed. Trustees now have a statutory power to remove most of the restrictions in those rules. But it is not always easy for trustees to decide exactly which restrictions to remove, and many scheme rules therefore still include their pre-April 2012 protected rights rules.

Most schemes with protected rights rules included a rule that any short service refund paid to an early leaver could not include member contributions which counted as protected rights. However, if a short service refund paid after 6 April 2012 does not include **all** member contributions, strictly speaking it would have been an unauthorised payment, triggering a tax penalty.

Facts

HMRC has passed regulations which provide that where a short service refund does not include all member contributions due to the scheme rules prohibiting the refund of former protected rights, the refund will still be an authorised payment. The regulations came into force on 8 August 2012.

Comment

These regulations will provide a useful easement for schemes which have yet to amend their rules.

HMRC has also confirmed that, where a short service refund was paid prior to 6 April 2012 and did not include a member's protected rights, there will be no tax penalty if the trustees now pay a second short service refund of the protected rights (provided that the scheme rules have been amended to allow the payment).

Katherine Dixon

TUPE: clarification on the transfer of enhanced early retirement rights

Courts provide more clarity about which early retirement rights transfer under TUPE but many questions remain

Summary

The High Court has provided some clarification on the transfer of enhanced early retirement rights under occupational pension schemes under the Transfer of Undertakings (Protection of Employment) Regulations 2006 (**"TUPE"**).

Background

Generally, where a business is sold or outsourced, employees' terms of employment transfer under TUPE to the buyer/service provider. However, there is a carve-out from this rule so that occupational pension scheme rights do not transfer under TUPE. Case law has decided that this carve-out does not apply to all rights to an early retirement pension, and that some rights relating to enhanced early retirement do transfer.

Facts

The case arose from the sale of a business by Procter & Gamble (**"P&G"**) to Svenska Cellulosa Aktiebolaget (**"SCA"**). The sale agreement provided for the purchase price to be adjusted to take account of any accrued pension liabilities which transferred to SCA under TUPE. P&G's pension fund (the **"P&G fund"**) was a defined benefit scheme. Its rules allowed early retirement from service with employer consent. The transferring employees became deferred members of the P&G fund on the sale to SCA. On early retirement as deferred members, they would miss out on two "enhancements" that were available to active members retiring from service:

- a bridging pension payable until state pension age; and
- for those with less than 15 years' continuous service, the ability to accrue further service to bring them up to 15 years (at which point more generous early retirement reduction factors would apply to the pension).

Decision

The court held that:

- Because the member would have needed employer consent in order to enjoy the enhanced early retirement benefits (if he or she had remained an active member of the P&G fund), what transferred under TUPE was only a right to be considered for early retirement on favourable terms. It was therefore open to SCA to decide not to give consent, though it should act in good faith in taking that decision.
- The liability that transferred to SCA was the liability to provide the enhancements, not the whole of the early retirement benefit. The deferred pension to which the member was already entitled from the P&G fund satisfied the liability for the standard level of benefits and SCA did not have to duplicate those benefits. Otherwise, the employee would get a windfall benefit.

- Even if the member's pension came into payment before NRD, the pension instalments payable after the member reached NRD should be categorised as "old age benefits" and were therefore within the carve-out from TUPE.

Comment

The decision provides some useful clarification, but leaves open important issues such as how to put a value on early retirement enhancements where these are not provided as of right; how a buyer should exercise the power to consent to early retirement; and, if an enhanced early retirement benefit becomes an old age benefit after NRD, who is liable to provide the enhanced element of the benefit after NRD. We understand that the case is to be appealed.

Martin Scott

This article is based on a bulletin previously published in PLC Magazine.

TUPE transfers from public sector schemes: changes ahead

Fair Deal policy to be replaced by continued public sector scheme membership

Summary

The Chief Secretary to the Treasury, Danny Alexander, announced in a written statement on 4 July 2012 that the Government has reviewed its "Fair Deal" policy and will be making changes to it. In future, employees outsourced from the public sector will remain as members of the relevant public sector pension scheme.

The current Fair Deal policy

The Fair Deal policy applies where private sector employers take on employees who are compulsorily transferred from the public sector. It requires the new employer to offer those employees a pension scheme which provides benefits for future service which are "broadly comparable" to those provided by their public sector scheme, and which will also accept a bulk transfer from the public sector scheme so as to provide those employees' accrued benefits as well.

Where the employees concerned are transferred from local government, the new private sector employer can meet its obligations by participating in the Local Government Pension Scheme, though this is not mandatory. Where this option is not available, or the employer decides not to take it up, a private sector employer can currently meet the "broadly comparable" test either:

- by obtaining a scheme "passport" from the Government Actuary's Department (**"GAD"**), which lasts for up to two years – though obtaining it can be a long and complex process – or
- by seeking a one-off certificate of broad comparability from GAD for a particular transfer.

In either case, in practice there are difficult issues for private sector employers about the level of bulk transfers to be accepted.

Announced changes

The key change that the Government is going to make is that transferring employees will continue as members of their public sector scheme, both on the first transfer and on any subsequent TUPE transfer. The current broad comparability and bulk transfer approach under the Fair Deal policy will cease to apply.

The Treasury statement says that the Government will put forward detailed implementation proposals this autumn.

Comment

In itself, this change will mean an end to the need to think about passports and certificates of broad comparability, but it should otherwise have little impact on trustees.

However, there remain some areas of genuine uncertainty which should be clarified later this year. In particular, it is not clear whether there will be any special arrangements for employees who have already been transferred from the public sector and later return and wish to bring their pension rights back with them, and how that would be funded.

Ian Wright

Automatic enrolment: recent changes

Final changes made to the automatic enrolment regime before it comes into force, plus confirmation that salary sacrifice can be used

Summary

New legislation makes minor changes to the automatic enrolment regime which comes into force this October. HM Revenue & Customs (**"HMRC"**) has also confirmed that salary sacrifice can be used with automatic enrolment.

CARE schemes

Changes have been made to the criteria which CARE schemes (which provide benefits for each year of service based on a member's inflation-adjusted salary in that year) must satisfy in order to be used for automatic enrolment. These changes mean that, if a scheme's inflation adjustments involve both a guaranteed increase below the "minimum rate" (CPI or RPI capped at 2.5%) and a further discretionary increase, then the scheme can be used to meet the automatic enrolment requirements, provided that the scheme's funding and its statement of funding principles take account of the exercise of the discretionary power to provide increases at or above the minimum rate.

Revised staging date timetable

Automatic enrolment is being phased in over a five year period, starting with the largest employers (more than 50,000 workers) in 2012 down to the smallest employers (less than 50 workers) in 2015-2017.

The Government decided to change the staging dates for employers with less than 250 workers and has now finalised the staging date timetable. The revised timetable can be found on the Pensions Regulator's website.

Changes to disclosure regime

The disclosure regime has been changed to take account of the introduction of automatic enrolment as follows:

- trustees must provide basic scheme information to jobholders (i.e. those workers who are automatically enrolled) within one month of the trustees receiving the jobholder information from the employer; and
- basic scheme information must now explain how individuals who are eligible for scheme membership are admitted to the scheme, which will include whether they are automatically enrolled.

Where an individual becomes a member other than through automatic enrolment, the period within which the trustees must provide basic scheme information remains two months.

Salary sacrifice

Concerns have been expressed that salary sacrifice cannot be operated in conjunction with automatic enrolment without making the salary sacrifice arrangement ineffective for tax purposes. HMRC has now confirmed that using a salary sacrifice arrangement with automatic enrolment will not make the arrangement ineffective.

Comment

In the main these changes tidy up outstanding issues in relation to the automatic enrolment regime, and the confirmation that salary sacrifice can be used will be welcomed. Schemes which will be used as vehicles for automatic enrolment will need to ensure that their administration systems are reviewed to reflect the new disclosure requirements.

Sally Taylor

The Takeover Code: extension to pension scheme trustees?

Bidders may have to provide information to the trustees of the target's pension scheme

Summary

Under new proposals, trustees of pension schemes would receive prescribed information when another company (a bidder) proposes to take over a pension scheme's sponsoring employer (the target). The proposals, which would involve amendments to the Takeover Code (the **"Code"**), would cover both DB and DC schemes.

Consultation proposals

At present, bidders abiding by the Code have to disclose certain information to employee representatives of the target. The new proposals would extend these provisions so that information is also given to pension scheme trustees. Under the proposals:

- the trustees of the target's pension scheme would receive information on the offer and its implications for the scheme, and they would be able to communicate their views on those implications publicly;
- the bidder and the target's board would be bound for a year by any statements they make about action which will or will not be taken in relation to the pension scheme; and
- details of any future funding arrangements for the pension scheme agreed by the bidder and the trustees must be made public.

Comment

The proposed changes could mean that trustees of a target's pension scheme receive more information about a bidder's plans in relation to the scheme. However, it is likely that the bidder's statement of intention will be relatively high-level. Similarly, trustees will not be able to give a detailed opinion on the takeover's potential impact on the scheme until they have been able to hold full discussions with the bidder, and any such discussions will not normally take place before the takeover completes.

Devora Weaver

This article is based on a bulletin previously published in PLC Magazine.

Upcoming Pensions Group events at Mayer Brown

If you are interested in attending any of our events, please contact Katherine Dixon (kdixon@mayerbrown.com) or your usual Mayer Brown contact.

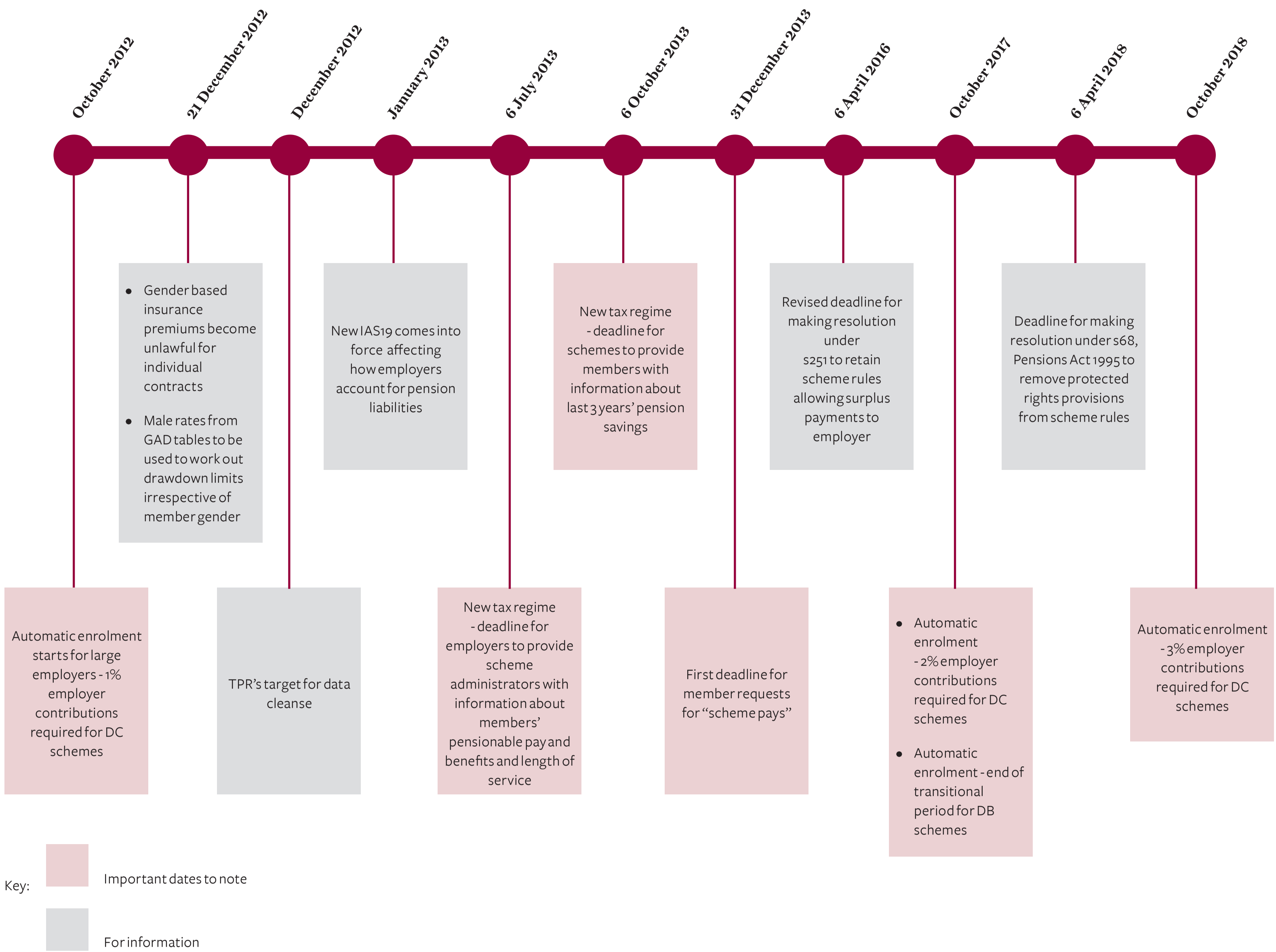
- **Pensions Group Seminar: Defined Contribution Pension Arrangements**
  Tuesday 18 September 2012 9am – 1.30 pm (including lunch)
  201 Bishopsgate, London EC2M 3AF

  This seminar will provide an informative update on the current state of play regarding the governance of DC arrangements and on some of the particular issues which arise in connection with DC arrangements as opposed to DB arrangements.

- **Trustee Foundation Course**
  Tuesday 2 October 2012 10.15am – 1.45pm (including lunch)
  201 Bishopsgate, London EC2M 3AF

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

Dates and deadlines



Katherine Dixon

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