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Trustee Quarterly Review

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Focus on flexibilities in the funding regime and sustainable employer growth

Scheme funding: Regulator's annual funding statement and the new statutory objective

Summary

The Pensions Regulator has published its second annual funding statement. The key message is that trustees and employers should make use of the flexibilities already provided in the statutory funding regime. "Sustainable growth" for the employer is to be highlighted in a new statutory objective for the Regulator.

The statement

The statement applies to DB schemes that have actuarial valuations falling between September 2012 and September 2013. It provides information about how to set assumptions relating to investment return and discount rates as well as setting appropriate contributions and recovery plans. Trustees must document any changes from previous valuations and consider any increased risk.

When setting deficit contributions, trustees should consider first whether the current rate can be maintained and then whether an increase or a decrease is appropriate. The statement places emphasis on the importance of retaining strength in employer covenants where possible, and the Regulator's chair has said that he would like to see "trustees agree long-term strategies with employers that protect the interests of retirement savers, whilst also enabling viable businesses to thrive and grow".

The Regulator promotes trustees seeking "open dialogue" with employers to agree how to use the flexibilities within the funding framework to reach appropriate and scheme-specific solutions. Trustees are expected to take an "integrated approach to addressing covenant, investment and funding risks" and must be able to demonstrate how these risks were assessed. The Regulator's view is that the outcome should be "neither overly prudent nor overly optimistic".

The new statutory objective

The Pensions Bill which is currently going through Parliament includes a new statutory objective which will require the Regulator to "minimise any adverse impact on the sustainable growth of an employer" when exercising its functions relating to scheme funding.

Comment

Devora Weaver

These developments may provide comfort to employers as trustees are being strongly directed to consider the financial position of the employer when setting contribution rates. Note that the new statutory objective is not to mitigate the impact on sustainable growth, but to "minimise" it, which is a fairly strong steer and possibly a recognition that the balance has been too heavily weighted in favour of protecting the PPF. The emphasis on a joined-up approach to covenant, investment and funding is to be welcomed.

Trustees to receive very flexible scheme amendment powers

Bridging pensions: trustee powers to reflect changes to state pension age

Summary

Many schemes contain "bridging pension" rules under which members receive a higher scheme pension till state pension age (**"SPA"**) and a lower pension after SPA. These were intended to give members broadly the same total pension income before and after their state pension starts. But increases to SPA mean that these rules often no longer work as intended. From 1 October 2013, trustees of schemes that provide bridging pensions will have wide new powers to modify their bridging pension rules in light of the changes to SPA. Employer consent will be required in all cases.

The new powers

Trustees will have a statutory power to modify their schemes, by resolution, in two ways: to change the age when bridging pensions stop, and to change the reduction that is applied at that point. Different modifications will be allowed depending on how the scheme's bridging pension rule was worded on 5 April 2010:

- If the rules said that bridging pensions would stop at an age between 60 and 65, the rules can be amended so that bridging pensions stop instead at any age between 60 and SPA.
- If the rules said that bridging pensions would stop at SPA, the rules can be amended so that bridging pensions stop instead at any age between 60 and 65.

Trustees will also be able to change the reduction that applies when a bridging pension ends. The new reduction can be higher or lower than the one that would otherwise have applied.

The new powers will be very flexible, and the usual restrictions on changes to accrued rights in contracting-out legislation and s67 Pensions Act 1995 will not apply to amendments made using them. However, there will be some restrictions:

- the amendment must not affect pensions in payment;
- the reduction when the bridging pension ends must be reasonable in light of the SPA changes;
- the new powers are available only if the scheme rules on 5 April 2010 provided for a bridging pension payable either until SPA or until an age between 60 and 65; and
- the amendment can be made only with employer consent. (In a multi-employer scheme, the employers can nominate a person as their representative for this purpose.)

Tax rules are also being changed to let schemes stop bridging pensions at SPA (or 65 if later) without incurring a tax charge.

Comment

Many trustees and employers will wish to take advantage of the new powers, in order to make reasonable adjustments to reflect changes to SPA that might not otherwise have been possible using the scheme amendment power.

Jonathan Moody

First DC-specific Code of Practice

DC scheme governance: new Code of Practice

Summary

The Pensions Regulator has published a final version of a new Code of Practice on the governance and administration of DC pension schemes (the "**Code**"). The Code is expected to come into force in November 2013.

The Code

The Code is directed at trustees of schemes that offer money purchase benefits or money purchase benefits with a DB underpin. This includes AVCs under DB pension schemes and DC sections in hybrid pension schemes.

The Code is divided into five core areas of scheme governance and sets out, for each of these areas, the features of a "quality" DC scheme, trustees' legal duties, and practical guidance to help trustees discharge their duties.

- **Know your scheme**: this focuses on trustees' knowledge of scheme documentation, benefit structures and their powers under the scheme rules. It notes that trustees with specialist knowledge or experience (such as professional trustees) are expected to have a higher level of knowledge than lay trustees. Trustees are expected to review their skills and knowledge, and to undertake training on a regular basis. It does not impose obligations additional to the "TKU" requirements.
- **Risk management**: the Code highlights the importance of adequate internal controls in managing risk, and sets out specific risk areas for DC schemes, including fraud (in particular pensions liberation), investment, administration and operational procedures. Risks need to be evaluated on their likelihood of happening and the potential impact on the scheme.
- **Investment**: the Code highlights that members bear the investment risk. Trustees therefore need to be clear what their investment powers are and to take advice from professionals when appropriate. A key decision for trustees is setting the default investment strategy.
- **Managing conflicts of interest and relations with advisors**: the Code recognises that some conflicts may be inevitable, and emphasises the need to properly identify, monitor and manage them. The Code also focuses on the need for trustees to effectively manage their relationships with professional advisors, including getting "value for money".
- **Administration**: this focuses on the need for trustees to maintain accurate and up-to-date member data and builds on the Regulator's record-keeping guidance. Trustees should carry out a data review exercise annually or at other appropriate intervals.

The Regulator suggests that, whilst trustees need to be familiar with the Code as a whole, they should also work through each section systematically, prioritising certain sections.

Melissa Pullen

Comment

The Code does not say anything particularly new about DC governance, but rather brings together in one place the elements of other codes of practice which are relevant to DC schemes. However, it is helpful for trustees of DC schemes to have a code of practice which is specific to DC schemes rather than having to work through codes of practice which are principally relevant to DB schemes.

Code focuses on maintaining the flow of contributions

Contributions to DC schemes: revised Code of Practice

Summary

Following a consultation in 2012, the Pensions Regulator has published a revised version of its Code of Practice (the **"Code"**) on reporting late payment of contributions to occupational DC pension schemes. The revised code is expected to come into force this autumn.

The revised Code

The Regulator's review of the Code was prompted by the introduction of automatic enrolment, as it is expected that most schemes used for automatic enrolment will be DC schemes. The revised Code deals, in particular, with trustees' duties to check that contributions (paid by the employer or deducted from members' pay) are correct and paid on time, and to report to the Regulator any failure to pay contributions which is likely to be materially significant to the Regulator.

The revised Code:

- applies to all DC occupational schemes regardless of size (currently there is an exemption for those with fewer than five members);
- makes it clear that trustees can use a risk-based and proportionate monitoring process (rather than checking every contribution);
- emphasises that employers have the primary responsibility to ensure that contributions are paid on time – the Regulator has published a separate employer guide on this; and
- provides more detail on the Regulator's intended enforcement approach. Trustees will be expected to try to resolve a situation before reporting non-payment. In particular, they should make at least three attempts to contact the employer within the 90-day period following the due date for payment. If that does not succeed, the Regulator could (if it is an automatic enrolment scheme) decide to issue an unpaid contributions notice. It can also issue a fixed penalty of £400, with further escalating penalties for continuing non-compliance.

Comment

Beverly Cox

Some of the proposals in last year's consultation have not been carried through into the final version of the Code, due to respondents' concerns. Trustees will welcome the fact that the Regulator has dropped the proposal to tell members about a failure to pay contributions at the same time as reporting it to the Regulator, which could have raised unwarranted concerns. The confirmation that a risk-based and proportionate approach is acceptable (and guidance on what that means) is also helpful.

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

Individuals to have two ways of protecting their pension savings

2014 reduction in lifetime allowance: individual and fixed protection

Summary

HM Revenue & Customs is consulting on proposals for a so-called "individual protection" regime, which the government plans to introduce in connection with the 2014 reduction in the lifetime allowance (**"LTA"**). Individual protection will be available alongside a "fixed protection" regime which will operate much as it did when the LTA was reduced to £1.5 million in 2012.

Consultation

With effect from 6 April 2014, the LTA will fall from £1.5 million to £1.25 million. The 2014 fixed protection regime will allow members with pension savings valued at over £1.25 million to retain the higher LTA of £1.5 million from 6 April 2014. Individuals will be able to apply for fixed protection 2014 from 12 August 2013; applications must be received by HMRC by 5 April 2014. In broad terms, fixed protection will be lost if the member accrues further pension benefits after 6 April 2014.

The new form of protection, individual protection, will not be lost if members accrue further benefits. The proposed details of the individual protection regime include the following:

- People will be eligible to apply for individual protection if they have pension savings of over £1.25 million at 5 April 2014. Individual protection will not be offered to people who already have so-called primary or enhanced protection. But people who applied for fixed protection in connection with the 2012 or 2014 reductions in the LTA (**"FP12"** and **"FP14"** respectively) *will* be able to apply for individual protection on top.
- Holders of individual protection will have a personalised LTA equal to the value of their pension savings on 5 April 2014 (subject to a maximum of £1.5 million). This amount will not increase unless the standard LTA later exceeds the individual's personalised LTA.
- Where someone has individual protection in addition to FP12 or FP14, the fixed protection will take precedence. Individual protection will become relevant only if the individual loses the fixed protection.
- It will not be possible to lose individual protection, so there will be no rule against someone with individual protection making further pension savings (though they will lose any fixed protection that they have if they do so). If the value of the individual's benefits on retirement exceeds their personalised LTA, the excess will be subject to the LTA charge, unless the standard LTA has gone up at the time and the value of their benefits does not exceed the new standard LTA.
- Individuals must apply to HMRC for individual protection with a valuation of their pension savings as at 5 April 2014. A three-year application period ending on 5 April 2017 is proposed, to allow for the fact that valuations as at 5 April 2014 may take some time to produce and will not be available until after that date.

Comment

The proposed individual protection regime tackles one of the criticisms of the FP12 regime which was the ease with which FP12 could be lost by the member accruing further benefits. However, the existence of personalised LTAs on top of the existing standard and other protected LTAs will add to the administrative burden for schemes.

In practice, individual protection is likely to appeal to many individuals with savings over £1.25 million as it could act as a fall-back to deal with investment losses in relation to money purchase rights. However, the decision whether to apply also for FP14 and cease pension savings is likely to be less clear cut for members with benefits between £1.5 million and £1.25 million, particularly where employers do not offer a cash alternative to continued pension savings. Trustees and employers may wish to ensure that members are aware of their options and have the right information to make an informed decision, but will need to be careful not to be too helpful and thereby run the risk of potential liability where a member decides he made the "wrong" decision.

Ian Wright

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

Explanation of Regulator's approach to prohibition of trustees

Prohibition of trustees: Regulator statement

Summary

The Pensions Regulator has published a statement explaining the policy it will follow in exercising its powers to prohibit a person from being a trustee. The statement came into effect on 25 June 2013.

The statement

The Regulator has power to prohibit a person from being a trustee if its Determinations Panel is satisfied that they are not a "fit and proper person". The Regulator is required by law to prepare and publish its policy in relation to the exercise of this power.

As well as setting out the procedures for issuing (and appealing against) prohibition and suspension orders, the statement also explains how the Regulator will decide whether a trustee is a "fit and proper person". In particular, the Regulator will consider any information which concerns the trustee's:

- honesty and integrity;
- competence and capability; and
- financial soundness.

The Regulator notes that trustees who repeatedly fall below the appropriate standards of knowledge and understanding may be prohibited, particularly if no attempt is made to attain the relevant learning. In addition, the Regulator may prohibit a professional trustee if they consistently fall short of the standards that the Regulator reasonably expects from pensions professionals.

The statement also sets out the Regulator's position on the charging of fees for trustee services. Broadly, trustees must be authorised to charge fees, the fees must be reasonable, and the work for which they charge must be necessary. Any attempt to hide the real amount being charged by the trustee will be a cause for concern for the Regulator.

Comment

Whilst most trustees, professional or otherwise, are unlikely to ever face the possibility of being prohibited from being a trustee, the Regulator's statement is a useful summary of its expectations in relation to trustee behaviour and conduct.

Abigail Cohen

Revised IORP Directive will not contain new funding requirements

EU solvency requirements: on hold

Summary

The European Commission is putting on hold its earlier plan to introduce solvency requirements for occupational pension schemes that would have been significantly more onerous than current funding requirements.

Announcement

The Commission is reviewing the IORP Directive which sets out the European legislation governing occupational pension schemes. Amongst proposals for reform was the introduction of new funding requirements for pension schemes, based on the solvency requirements that will apply to insurance companies under EU legislation known as Solvency II. A number of countries, including the UK, strongly opposed this proposal. A preliminary study revealed that the proposals would have increased the funding shortfall in UK pension schemes by around £150 billion.

The Commission has now announced that the revised IORP Directive will not contain new funding requirements for pension schemes. However, insurers remain concerned that Solvency II, once introduced, will impact on insurers who provide pensions, but not occupational pension schemes, and they will continue to argue that in the longer term there should be a level playing field between different providers of pensions. Solvency requirements for occupational pension schemes are therefore likely to remain an open issue.

Olivia Mylles

Comment

While the Commission's announcement has been welcomed, this could be a temporary reprieve given its commitment to continue its work in this area. In the meantime, the Commission expects to publish proposals to improve the governance and transparency of occupational pension schemes in the autumn.

Most UK schemes to be exempt under FATCA

FATCA: registered pension schemes exempt from reporting requirements

Summary

HM Revenue & Customs has published guidance which clarifies that all UK registered pension schemes, and some unregistered schemes, will not be subject to reporting requirements under the Foreign Account Tax Compliance Act (**"FATCA"**), a US Act which could have had material implications for UK pension schemes with investments in the US.

Guidance

In broad terms, FATCA imposes a 30% withholding tax on certain US investment income paid to "financial institutions" outside the US, unless they agree to provide certain information to the US Internal Revenue Service (**"IRS"**) about their US beneficiaries. As FATCA is very widely drafted, it could have treated UK pension schemes as financial institutions.

Last year the UK and the US signed an intergovernmental agreement on the implementation of FATCA. HMRC has now published guidance on implementation of the agreement. This clarifies that UK registered pension schemes will be "exempt beneficial owners" under the agreement, which means that they will have no reporting obligations in relation to US beneficiaries (and should not be subject to withholding under FATCA as it currently stands). Unregistered schemes will also be exempt beneficial owners if annual contributions are capped at £50,000 and benefits cannot be accessed before the age of 55 outside circumstances of serious ill health.

Whilst exempt schemes with US investments (whether held directly or through a pooled vehicle) will not need to register with, or report to, the IRS or HMRC, they may be asked to provide evidence to the managers of those US investments to show that they are entitled to benefit from the exemption.

Comment

The guidance provides welcome clarification that most UK schemes will not be subject to the onerous reporting requirements under FATCA. However, schemes will need to wait further for confirmation of exactly what evidence of their status as exempt beneficial owners they will need to provide.

Katherine Dixon

Spate of insolvency-related cases in recent months

Case law round-up

Hogan v Minister for Social and Family Affairs, Ireland

The Court of Justice of the European Union (**"ECJ"**) held that Irish legislation does not properly implement an EU directive which requires member states to protect accrued pension rights under occupational pension schemes in the event of the employer's insolvency, as members of Irish schemes are not guaranteed to receive at least 50% of their accrued benefits in that situation. Previous ECJ case law has held that "protection" for the purposes of the directive meant that employees should be guaranteed to receive at least half their accrued benefits. The decision raises the question of whether the UK is also in breach of the legislation as, in some cases, the PPF would not cover at least 50% of a member's pension benefits. The UK government has recently announced that the PPF compensation cap will be increased for long-serving members, which may go some way to resolving this issue.

In the matter of the Nortel and Lehman Companies

The Supreme Court held that, if a financial support direction (**"FSD"**) is issued after the insolvency of the recipient company, the liabilities arising under the FSD will rank alongside the debts that the insolvent company owes to its unsecured creditors and below the debts it owes to its secured creditors. This decision overturns the Court of Appeal's ruling that the liabilities counted as an expense of the administration or liquidation and therefore ranked above all the company's unsecured debts and ahead of some secured debts. The Supreme Court's decision means that liabilities arising under an FSD issued after the insolvency of the recipient company will now have the same priority as s75 debts.

LB Re Financing No 1 Limited v Trustees of the Lehman Brothers Pension Scheme

The Court of Appeal upheld the High Court's decision that the trustees of a scheme are "directly affected persons" for the purposes of the moral hazard legislation. This means that trustees can ask the Upper Tribunal to review a decision by the Pensions Regulator not to issue a contribution notice or a financial support direction.

Trustees of the Olympic Airlines SA Pensions and Life Insurance Scheme v Olympic Airlines SA

Martin Scott

The Court of Appeal overturned the High Court's decision that it had jurisdiction to wind up the principal employer of the Olympic Airlines pension scheme even though the employer (a Greek company) was already in liquidation in Greece. This is relevant for the pension scheme because the list of qualifying insolvency events in the PPF legislation does not include a Greek liquidation. This means that the scheme will not be eligible for PPF entry unless a UK winding up order is issued.

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. All events take place at our offices at 201 Bishopsgate, London EC2M 3AF.

TRUSTEE FOUNDATION COURSE

Tuesday 17 September 2013
Tuesday 10 December 2013

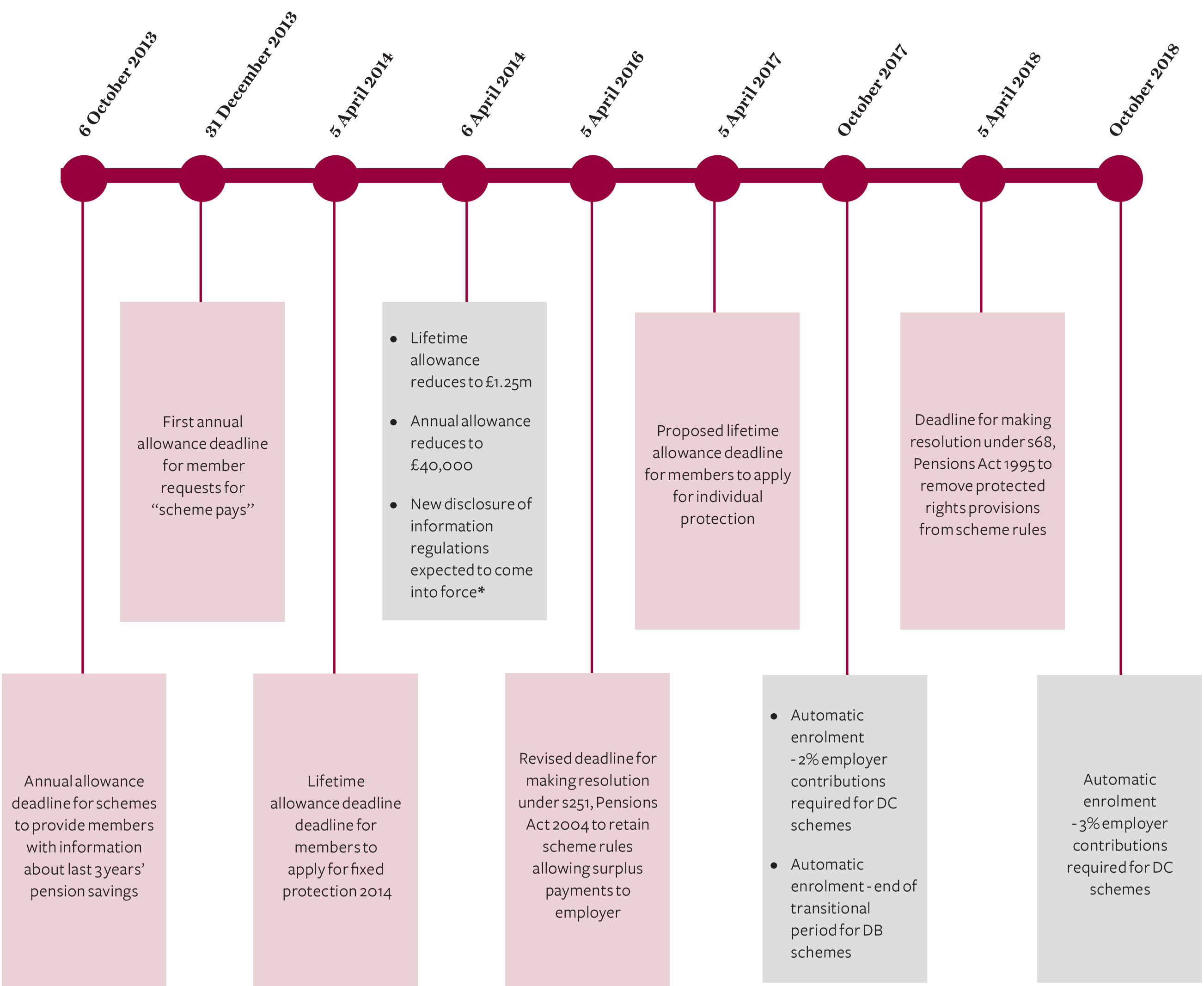
Our Foundation Course aims to take trustees through the pensions landscape and the key legal principles relating to DB funding and investment matters, as well as some of the specific issues relating to DC schemes, in a practical and interactive way.

TRUSTEE BUILDING BLOCKS CLASS

Tuesday 19 November 2013

Our Building Blocks Classes look in more detail at some of the key areas of pension scheme management. They are designed to be taken by trustees who have already taken our Foundation Course.

Dates and deadlines



Key:

Important dates to note

For information

*The Government has announced that the new disclosure of information regulations will now come into force on 6 April 2014 rather than 1 October 2013. The final version of the new regulations will be published this autumn.

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

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