MAYER • BROWN

Strictly Private & Confidential
February 2014

Trustee Quarterly Review

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Don’t forget! – PPF levy deadlines and new disclosure requirements

PPF levy deadlines

The relevant deadlines for submitting information and documents for the purposes of the 2014/2015 Pension Protection Fund levy are as follows:

31 March 2014 (5pm)

- scheme data to be updated on Exchange
- certification/re-certification of contingent assets (and submission of any accompanying hard copy documents)

30 April 2014 (5pm)

- submission of deficit reduction contribution certificates

30 June 2014 (5pm)

- submission of full block transfer certificates (and any accompanying hard copy documents)

New disclosure requirements

On 6 April 2014 the new disclosure of information requirements come into force. The key changes are:

- Some of the requirements relating to the basic scheme information that must be provided to new members have been combined and simplified, whilst other items of information which must currently be provided as basic scheme information will in future only need to be provided if the member requests them.
- There are slightly expanded basic scheme information requirements relating to what members can do with their benefits if they leave service before normal pension age, including a requirement to provide information on any applicable charges. There is also a new requirement, where members with money purchase benefits are concerned, to include a statement that the value of the member’s pension will depend on several factors including the amount of contributions paid, the performance of investments, and the cost of purchasing an annuity.
- Schemes that operate a lifestyling strategy (or plan to adopt one) will need to provide information about that strategy as part of the basic scheme information and again 5-15 years before the member’s retirement date (unless already provided to the member in the previous 12 months).
- The requirements for statutory money purchase illustrations (“SMPIs”) have been altered to allow schemes to produce SMPIs that are more personalised to their members by giving greater flexibility over the annuity assumptions that must be used and allowing lump sums to be illustrated separately.
- The requirements that apply when providing information electronically (i.e. via email or on a website) have been clarified, and the ability to provide information electronically has been extended to areas where it did not previously apply e.g. the provision of information about cash equivalent transfer values.

Schemes should note that, where relevant, existing members should be sent the information in the second and third bullet points above if they have not already been provided with that information.

Same sex marriages to take place from 29 March 2014

Same sex marriage: implications for pension schemes

The Marriage (Same Sex Couples) Act 2013 (the ***"Act"****) will come into force on 13 March 2014, and the first same sex weddings will be able to take place from 29 March 2014. The Government has published secondary legislation which deals with several important pensions issues.*

From 13 March, marriage between same sex couples will generally have the same effect as the marriage of opposite sex couples. This means, in principle, that any reference in law to marriage or to a spouse will apply in the same way to a same sex married couple as it does to an opposite sex married couple.

However, crucially for pension schemes, this does not alter the effect of any private legal instrument, such as a trust deed and rules, made before 13 March 2014. This means references in a scheme's current trust deed and rules to "spouse" etc. do not need to be read as including same sex spouses etc., but references in any trust deed and rules signed (or, potentially, amended) from 13 March should be read as including same sex spouses unless the document clearly provides otherwise.

Secondly, in the pensions context, the Act does not require same sex spouses to be treated any more generously than civil partners are currently treated. Same sex spouses will be entitled to the same death benefits as (opposite sex) spouses for service after 5 December 2005, plus (in a contracted-out scheme) the same GMP and post-1997 contracted-out benefits as would have been paid to a widower. As was the case when civil partnerships were introduced, schemes can choose to provide the same benefits to same sex spouses that they provide to opposite sex spouses

Trustees can use their scheme amendment power to include benefits for same sex spouses, but in some schemes such an amendment could have an adverse effect on contingent benefits for children or dependants. For example, some schemes' rules say that children's pensions are reduced if the member leaves a spouse. Ordinarily, reducing existing rights to a children's pension would raise issues under section 67 Pensions Act 1995 (**"s67"**) (which restricts amendments to rights that have already built up). But, in the context of rule amendments that provide for same sex spouses, new legislation says that s67 does not apply to an associated amendment saying that a same sex marriage affects other survivors in the same way as an opposite sex marriage.

For schemes with restrictive amendment powers that would prevent amendments to include provision for same sex spouses, the legislation also gives trustees a power to modify their scheme by resolution to provide benefits to same sex spouses and to treat other survivors' benefits in the same way as if the member was survived by an opposite sex spouse. This will require employer consent if the modification will provide same sex spouses with more than the statutory minimum.

Melissa Pullen

When deciding what level of benefits to provide to same sex spouses, trustees should be aware that the Government has agreed that, by July 2014, it will reconsider whether same sex spouses and civil partners should automatically be given the same pension rights as opposite sex spouses even in relation to contracted-in service before 5 December 2005.

Against this landscape, trustees and employers should be alert to the possibility that in future schemes may be required to provide same sex spouses with full opposite sex benefits in respect of all periods of service.

Draft code emphasises need for integrated risk management

DB scheme funding: Regulator consultation

The Pensions Regulator is updating its DB regulatory strategy, including in relation to funding where it will have a new statutory objective (once the necessary legislation is passed). The current wording for the objective is "to minimise any adverse impact on the sustainable growth of an employer". The Regulator recognises that "growth" will mean different things to different employers – for some it is a real prospect, while for others it will be about maintaining their position or slowing a business decline. There is to be a new DB funding policy and a new code of practice on DB scheme funding.

The new approach focuses heavily on both trustees and the Regulator understanding the risks in three key areas and how they interact: employer covenant, investment and funding. The draft code of practice says that trustees should adopt an integrated approach to risk management and should have in place a monitoring framework to maintain an appropriate risk balance. In particular, it suggests that if a scheme has separate investment and funding committees, strategic questions around the level of investment risk may be best handled by the funding committee.

In addition to managing risks and bearing in mind the sustainable growth of the employer, the draft code sets out a number of funding principles for DB schemes which are fairly familiar from its recent annual funding statements. In particular there is emphasis on good governance as leading to better outcomes, and on fair treatment for pension schemes relative to other creditors and stakeholders.

The Regulator's DB funding policy moves away from the "triggers"-based approach, with a focus on employer covenant strength. Under the new policy, the Regulator will assess and categorise schemes by covenant strength ("strong", "tending to strong", "tending to weak" and "weak"). It will then apply indicators to the schemes within each segment. The principal indicator is the balanced funding outcome (**"BFO"**) indicator. The BFO indicator compares the deficit repair contributions under the scheme's agreed recovery plan against the level of contributions deemed necessary by the Regulator to eliminate the deficit over the medium term (taking account of covenant strength, scheme maturity and funding level). It does not consider affordability for the employer, so there could be instances where a scheme justifiably falls short of the BFO. Falling short of the BFO will be one of the factors that the Regulator considers when setting its "risk bar", which will be used to prioritise its resources and to target policies and intervention. Other factors include the size of the scheme's liabilities (the bigger the scheme, the greater the likelihood of investigation) and the potential impact of intervention. The covenant and BFO measures will not be disclosed to schemes directly.

There is little apparent sympathy for employers concerned about possible future over-funding; no mention is made of trapped surplus and, when making decisions about funding and investment, the Regulator expects trustees to "unpack" asset-backed contribution arrangements and consider them as simply providing an income stream (with fallback plans where there is a risk of unlawful employer-related investment). So-called "double counting" of section 75 debts is also in the Regulator's sights.

Olivia Mylles

The joined-up approach proposed by the Regulator has been broadly welcomed by the pensions industry, though concerns remain about exactly what the Regulator means by double counting and whether it is right to lump all forms of it together alike. The consultation closed on 7 February 2014, and the new code of practice is expected to be in force by July 2014.

Importance of careful assessment of ABC proposals underlined

Asset-backed contributions: new Regulator guidance

*The Pensions Regulator has published further guidance on asset-backed contribution arrangements (**"ABCs"**) and how trustees should approach them.*

Broadly, ABCs are contractual funding arrangements where an employer transfers an asset into a special purpose vehicle for a specified period. The employer will make payments for the use of the asset and these payments provide an income stream to the pension scheme. The main advantage for the employer is that, structured correctly, the employer can benefit from an up-front tax deduction.

The guidance emphasises that, if trustees are considering an ABC, it is imperative that they consider and understand all the risks involved, take appropriate advice and consider alternative funding methods. The guidance says that in order to properly evaluate a proposal for an ABC, trustees will generally need extensive legal, actuarial, asset valuation, investment and covenant advice.

The guidance focuses on six key risks presented by ABCs: an inflexible schedule of payments delaying full funding; weak underlying assets or limited legal claims on those assets; masking of the scheme's overall risk profile; weakened employer covenant; the cost and complexity of establishing an ABC; and the potential risk that the ABC structure might be found to contravene the restrictions on employer-related investment.

An ABC would sit alongside a scheme's schedule of contributions and recovery plan. To mitigate the risk that an ABC structure could be found to be illegal, the guidance says that ABCs should include an underpin protecting the scheme's position in case the ABC is declared void.

There is no doubt that ABCs are costly and complicated structures to set up and to operate. However, they can be useful funding methods in certain circumstances. The crucial element for trustees to focus on is whether the asset underlying the ABC would have a value independent of the employer should the employer become insolvent, and whether the asset would be capable of sale in those circumstances.

The guidance is helpful as it makes clear that the Regulator will not automatically challenge ABCs provided that trustees fully understand and consider all the risks involved, obtain extensive advice, and conduct appropriate due diligence before agreeing to them.

Devora Weaver

Individual protection regime to go ahead largely as proposed

Autumn Statement 2013: individual protection regime finalised

*HM Treasury has published the Autumn Statement 2013 as well as draft legislation for the individual protection regime that will apply in respect of the 2014 reduction in the lifetime allowance (**"LTA"**).*

In June 2013, HM Revenue & Customs (**"HMRC"**) and the Treasury consulted on proposals for an "individual protection" regime that is to apply in respect of the 2014 reduction in the LTA. The Autumn Statement published in December confirmed that the Finance Bill 2014 will provide for this, and the Treasury and HMRC have published draft legislation, explanatory notes and guidance, together with a response to the consultation.

Holders of individual protection will receive a protected LTA equal to the value of their pension savings on 5 April 2014 (subject to a maximum of £1.5 million). What will distinguish individual protection from "fixed protection" is that continued benefit accrual will not result in the loss of the individual protection. This may be a particular advantage for DC members whose "pots" could fall in value and who might appreciate the opportunity to top them up again if that happens. Members will be able to apply for individual protection from 6 April 2014 until 5 April 2017 (although the application form will not be available online until August 2014). It will be possible to hold both fixed and individual protection and, in a change to the consultation proposals, to hold both enhanced and individual protection. It will not be possible to hold both primary and individual protection.

Other pensions-related announcements in the Autumn Statement included the following:

- The increase in state pension age to 68 is likely to be moved from the current date of 2046 to the mid-2030s, and state pension age could increase further to 69 by the late 2040s.
- The basis on which the income drawdown tables are formulated will remain unchanged following the Government Actuary's Department's review of the tables.

Other than the concession allowing individuals to hold both enhanced and individual protection, the individual protection regime remains very much as proposed in the consultation. It seems likely that most members with enhanced or fixed protection will be interested in also obtaining individual protection, as a fallback should they lose their enhanced or fixed protection. Members intending to apply for fixed protection of an LTA of £1.5 million should note that applications for fixed protection must be received by HMRC by 5 April 2014 – irrespective of whether the member also intends to apply for individual protection.

It will be the individual's responsibility to apply for the protection; not that of employers or trustees, but trustees may wish to ensure that members know about the option. Trustees may also find that their schemes receive requests for information about the value of DC pots as at 5 April 2014 from members who are thinking of applying for individual protection.

Jonathan Moody

Encouraging Advocate-General opinion but unclear HMRC guidance

Recovery of VAT on investment management costs: recent developments

There have been two recent developments in the ongoing saga of whether VAT charged on pension scheme investment management costs is recoverable. Firstly, the Advocate-General has given his opinion in the ATP PensionService case (which is currently being considered by the Court of Justice of the European Union (the ***"ECJ"****)) which will determine whether investment management services provided to DC pension schemes are exempt from VAT. Secondly, HM Revenue & Customs (****"HMRC"****) has published long-awaited guidance setting out its revised policy on the recovery of VAT on services provided to DB pension schemes following the PPG case last year.*

ATP PensionService

As a matter of EU law, investment management services provided to a "special investment fund" are exempt from VAT. The Advocate-General's formal advice to the ECJ in this case suggests that an occupational pension scheme should be considered a "special investment fund" if:

- the scheme pools the assets of several members;
- the scheme allows risk to be spread over a range of securities; and
- most importantly, the members bear the investment risk.

It is for national courts to decide whether a scheme meets these criteria.

The Advocate-General's opinion offers DC schemes in the UK hope that they may count as "special investment funds" since, unlike members of DB schemes, members of a DC scheme do bear the investment risk. (Last year the ECJ held that DB schemes were not "special investment funds".)

The ECJ will give its decision on 13 March 2014. The ECJ is not bound to follow the Advocate-General's opinion but does so in the majority of cases. However, even if the ECJ agrees with the Advocate-General, much may still depend on HMRC's interpretation of the ECJ's decision.

Revised HMRC guidance on VAT recovery

Last year, in the *PPG* case, the ECJ decided that an employer was entitled to deduct VAT charged on both administration and investment management services provided to its pension scheme if there was a direct and immediate link between the services and the employer's economic activities as a whole. The ECJ held that it was for national courts to decide whether there was a direct and immediate link.

Prior to the *PPG* decision, HMRC's policy had been that VAT on pensions administration costs was recoverable by the employer, but not VAT on investment management costs. HMRC allowed 30% of the VAT on investment management services to be recovered by the employer, unless the employer could persuade HMRC that a higher proportion should be recoverable. This was on the basis that 30% of investment management services related to pensions administration (whether or not this was the case).

HMRC has now published guidance setting out its revised policy on the recovery of VAT in light of the *PPG* decision. Unfortunately, the position that it sets out is by no means clear.

In principle, HMRC accepts that VAT on costs relating to pensions administration and investment management services can be recoverable by the employer if there is a direct and immediate link between the services received and the employer's economic activities. The historic 70/30 split has been scrapped meaning there is, in theory, no upper limit on the level of VAT that employers can recover, but also no 30% lower limit.

However, HMRC will not allow VAT to be recovered by the employer if:

- the services are not deemed to have been supplied to the employer; or
- investment management costs alone are incurred.

Also, where the services *are* deemed to have been supplied to the employer and VAT is recoverable by the employer, but the pension scheme bears the cost of the services (whether by way of reimbursement or a set-off against pension contributions), HMRC will require the employer to charge the pension scheme an equivalent amount of VAT in respect of the amounts reimbursed.

The net effect of the guidance is that it is unfortunately now harder to say with any certainty in which circumstances an employer will be able to recover VAT. As a general rule, most businesses will be net losers; financial services businesses may be net gainers. The revised policy applies with effect from 3 February 2014, but there will be a six month transitional period where, if the pension scheme is invoiced for the services, the 70/30 split will continue to apply.

The ECJ's decision in *PPG* offered the hope of improved VAT recovery on investment management costs. It is difficult to predict how HMRC will seek to apply its revised policy to any particular pension scheme and its associated employer without a detailed assessment of the particular circumstances of both scheme and employer, but HMRC seems to be using *PPG* to make VAT recovery in this area harder, not easier, than before.

Peter Steiner

Regulator encouraging schemes to adopt a "comply or explain" approach

DC governance: Regulator tools for assessing compliance

The Pensions Regulator has published a range of tools to assist trustees of DC schemes to assess the extent to which they are in compliance with the Regulator's new code of practice and guidance on the governance and administration of DC schemes, and to prepare a governance statement.

In November 2013, a new Regulator code of practice on the governance and administration of DC pension schemes came into force. It was accompanied by regulatory guidance and a regulatory strategy. The Regulator wants trustees of DC schemes to publish an annual governance statement confirming the extent to which their schemes comply with the requirements of the code and the guidance, and explaining any areas of non-compliance. Although publication of a governance statement is voluntary, the Regulator expects schemes to "fully embrace this 'comply or explain' approach", and will monitor the take-up and quality of governance statements.

The Regulator has published a template governance statement for trustees to use. It is accompanied by an assessment template covering each of the 31 "quality features" that the Regulator expects DC schemes to possess. Both the governance statement and the assessment template can be adapted to suit the individual needs and circumstances of the scheme. As a minimum, the Regulator expects the governance statement to:

- confirm the presence of the DC quality features in the scheme;
- explain any instances where a feature is not present, but where the scheme complies with the underlying law or good practice;
- set out any action plans that are in place to embed a feature or improve an existing feature to a "best practice" level; and
- set out the trustees' priorities for the following scheme year.

The governance statement should be published in a way that makes it easily available to members and employers e.g. by including it in the scheme's annual report and accounts or by putting it on the scheme's website. The assessment does not need to be published, but the information as to how the scheme meets the quality features should be available on request to members, employers and the Regulator.

Katherine Dixon

Trustees of DC schemes will need to decide whether to produce a governance statement and, if they decide to do so, will need to consider carefully how to complete the statement. The process of assessing the extent to which the scheme possesses the 31 quality features is likely to take some time and to require input from the scheme's professional advisers.

DWP proposals to promote greater risk-sharing

Defined ambition: a new era for UK pension provision?

At the end of last year the Department for Work and Pensions (the ***"DWP"****) consulted on its proposals for a new era of "defined ambition" pension provision. The DWP hopes to facilitate greater risk sharing between employers and employees, as a reaction to the marked shift in the industry from DB to DC pension provision.*

The consultation looks at three main options:

Flexible DB

The proposal is to remove some of the legislative constraints that have made DB schemes increasingly expensive to maintain. Suggestions for reducing the statutory burden on DB schemes include:

- removal of the statutory requirement for annual increases to pensions in payment, instead allowing schemes to provide discretionary one-off increases in any year depending on the scheme's funding (without necessarily being obliged to keep the pension at its increased level in future years);
- automatic conversion of a member's DB benefits to a DC pot if the member leaves employment before retirement; and
- allowing the employer to adjust the scheme's normal pension age in line with changes to life expectancy as determined by a Government index.

A statutory override may also be provided to enable employers to amend scheme rules without the need for trustee and member consent.

Guaranteed DC

In the DC arena, the proposals mainly focus on offering members some guarantee in relation to their benefits. Examples put forward include:

- Money back guarantee: the member's fund is guaranteed to be not less than the contributions paid.
- Capital and investment return guarantee: a fiduciary buys a form of capital guarantee, and possibly also some level of guaranteed investment return, for a fixed period on behalf of the member.
- Retirement income insurance: each year from a certain age (e.g. 50) part of the member's fund is used to buy an income insurance product which grows as further insurance is purchased and which pays out if the member's fund reduces to zero.
- Pension income builder: each year a proportion of the member's contributions are used to buy a deferred annuity, with the remainder being invested in a collective pool of risk-seeking assets.

Collective DC

Collective DC schemes are schemes in which contributions are pooled and a member's pension paid from the collective fund. Employers pay a fixed rate of contributions with no further funding liability, and the member is given a target pension income. This target income is not guaranteed, and the ultimate retirement income paid depends on the collective fund's assets but, if the asset level permits, member receive a higher pension income than the target income.

Abigail Cohen

Many commentators have argued that, in the DB space, these proposals are too late to encourage employers who have already moved to DC to change back to a form of DB provision. However, they may encourage those employers who still provide a form of DB accrual to continue to do so. And over the longer term, employers may find them more attractive as their workforces start to discover how inadequate some DC pensions turn out to be and demand something better.

Contractual pensionable pay cap did not breach implied duties

Changing pension benefits by contractual agreement: implied employer duties

The Pensions Ombudsman has decided that an employer which sought to impose a pensionable pay cap by contractual agreement with employees was not in breach of implied duties arising from an employee's contract of employment.

Mr B was employed by the BBC and was a member of a final salary section of its pension scheme. The scheme had three sections. The BBC decided that, in order to reduce the scheme's deficit, it would impose a pensionable pay cap. Three options were put to members:

- remain in their current section and be subject to the cap;
- opt out of their current section and join a new career average section, which would not be subject to the cap; or
- opt out of the scheme altogether and join a DC arrangement.

Where a member chose the first option, the cap was imposed by contractual agreement – any future pay increase was to be offered only if the member first agreed that the cap would apply. (The courts decided in 2012 that agreeing to the cap would not breach the statutory prohibition on surrendering pension benefits.)

Mr B complained to the Ombudsman that the BBC's actions in seeking to impose the cap by contractual agreement breached the BBC's implied duties of trust and confidence and of good faith. Employers are subject to these implied duties in their dealings with their employees, and case law has confirmed that the duties apply in the pensions context.

The Ombudsman referred to some "pointers" when considering whether an employer has acted in breach of its implied duties:

- The implied duties are not fiduciary duties and are not to be assessed by reference to concepts of reasonableness. What seems reasonable to an employer may seem unreasonable to an employee and vice versa.
- An employer may take its own interests into account.
- A decision by an employer in the pensions context which is irrational or perverse might offend the obligation of good faith.
- An employer must not exercise its powers under a pension scheme so as seriously to damage the relationship of trust and confidence between the employer and the employee.

The Ombudsman decided that the BBC's actions had not breached its implied duties. In light of the level of the scheme's deficit, the likely future increase in liabilities, the efforts that the BBC had taken previously to limit costs, and the BBC's status as a public body that is largely funded by the public purse, the BBC's decision to impose the cap could not be seen as irrational or perverse. This was further demonstrated by the fact that the BBC had not taken more extreme alternatives that other employers had taken (such as closure of the scheme) and had given members an alternative option to accepting the cap (joining the new career average section).

Giles Bywater

The Ombudsman's decision will provide some reassurance to employers who are proposing to change pension benefits by contractual agreement, or who have already done so. But employers still need to have a sound economic rationale for the proposed changes, to consider the viability of alternative options, and to ensure that members are fully informed about the proposed changes and their implications and are given a genuine choice whether or not to accept them.

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

25 February 2014
20 May 2014
16 September 2014
9 December 2014

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 CLASSES

17 June 2014 – topic to be confirmed
18 November 2014 – topic to be confirmed

Our Building Blocks Classes look in more detail at some of the key areas of pension scheme management.

ANNUAL PENSIONS FORUM

2 April 2014

Our Annual Pensions Forum takes a look back at some of the key developments over the last 12 months and looks forward to expected developments in the coming year.

Please speak to your usual contact in the Pensions Group if you have any questions on any of the issues in this Trustee Quarterly Review.

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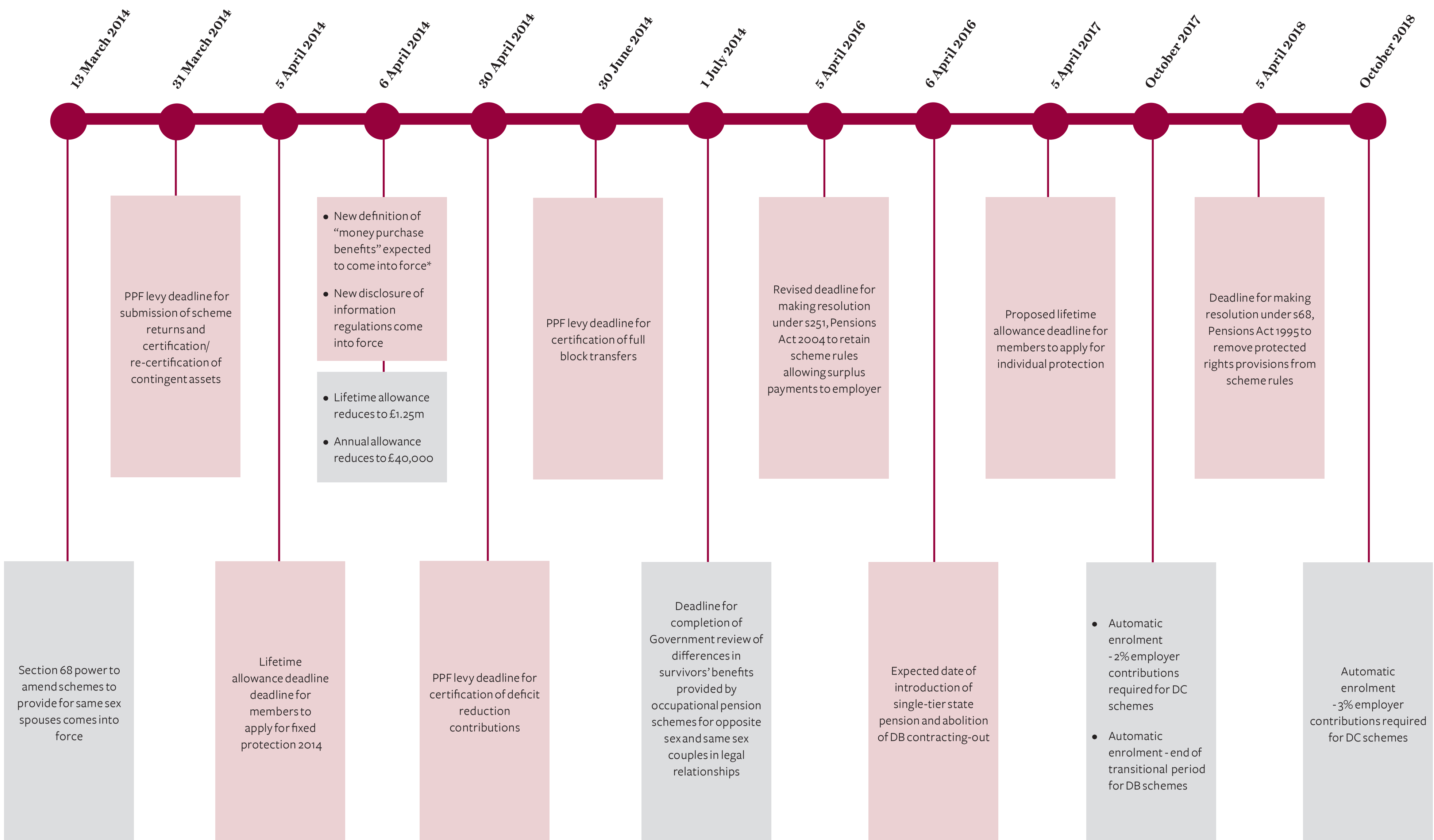
Dates and deadlines



* Given that the finalised implementing regulations have not yet been published, it seems unlikely that the definition will in fact come into force on this date. No official announcement has been made, but we understand that some schemes have been told by the DWP that the implementation date will be delayed.

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