MAYER • BROWN

November 2014

Trustee Quarterly Review

Quarterly update for pension scheme trustees

Introduction

Welcome to the November 2014 edition of our Trustee Quarterly Review. The Review is published by the Mayer Brown Pensions Group each quarter, and looks at selected legal developments in the pensions industry over the previous quarter that we believe are of particular interest to trustees of occupational pension schemes. Each article summarises the relevant development and provides a short commentary on its likely implications for trustees. The Review also includes details of upcoming Pensions Group events at Mayer Brown, and a timeline of important dates and expected future developments.

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

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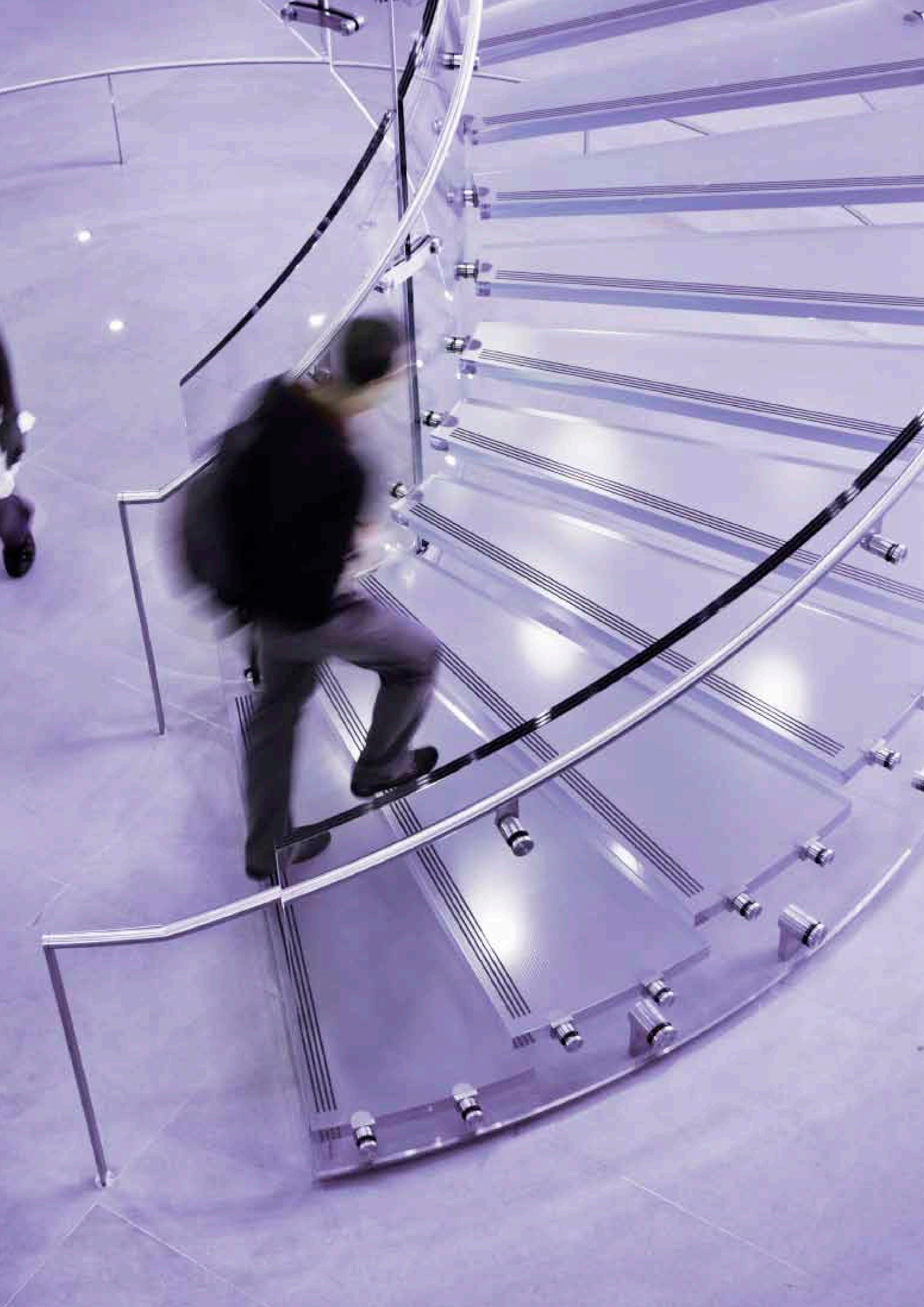


PPF levy: 2015/16 – 2017/18 levy framework finalised

In October, the Pension Protection Fund (the **"PPF"**) published a response to its May 2014 consultation on the proposed levy framework for the three years from April 2015 (the **"consultation"**) (see our August 2014 Trustee Quarterly Review for details of the consultation). The PPF consulted further on certain points, including on asset-backed contribution (**"ABC"**) arrangements. The PPF also published draft rules for the 2015/16 levy (the **"determination"**) for consultation. Responses were invited by 13 November 2014. The final determination will be published before Christmas.

New insolvency risk model

The PPF reported strong stakeholder support for the move to Experian (the PPF's new insolvency risk provider) and the new PPF-specific model for assessing insolvency risk. Other key conclusions from the consultation include:

- credit ratings will not be used in place of scores generated by the new model;
- the number of levy bands will remain at ten as proposed; and
- transitional protection will not be offered.

The PPF expects that the new model will result in a levy reduction for most schemes, but that over 600 schemes will see their levy rise by at least £50,000. The estimated levy for 2015/16 across all schemes is £635m, compared to £695m in 2014/15, and the PPF expects further reductions in 2016/17 and 2017/18.

Parent company guarantees

The proposed new certification requirement (requiring trustees to certify a fixed amount that the guarantor could pay) will be implemented as planned. The PPF will also adjust the guarantor's insolvency risk scores to reflect the impact that meeting the guarantee would have, but this approach has been modified to address a potential double counting issue.

ABC arrangements

The consultation included proposals to recognise ABC arrangements for levy purposes only if the underlying assets were cash, UK property or securities. Following the consultation, the PPF has decided that ABCs may be recognised regardless of the underlying asset. But trustees will be required to obtain an annual valuation (upon which the PPF can rely) of the underlying assets on the "insolvency basis". The amount certified cannot be more than the lower of the insolvency value of the asset and the fair value reported in the most recent scheme accounts.

"Last man standing" schemes

In the consultation, the PPF proposed to reduce the levy discount enjoyed by "last man standing" (**"LMS"**) schemes, and to require schemes claiming the discount to obtain legal advice confirming their LMS structure. The PPF has confirmed that this advice need not be obtained annually, except where the scheme rules on scheme structure have been changed in the intervening period.

The legal advice does not have to have been taken specifically for the purposes of the PPF levy, provided it is clear and unambiguous as to the scheme's structure. For the 2015/16 levy year, the Regulator will write to all schemes that have identified themselves as LMS for that year to request confirmation that the necessary advice been obtained. This confirmation must be provided by 31 May 2015.

Comment

LMS schemes and schemes with ABCs and parent company guarantees will need to understand the new certification requirements and plan how to deal with them. Trustees of LMS schemes (or of any multi-employer scheme intending to claim the LMS discount) should be mindful of the requirement to obtain legal advice on LMS scheme structure and of the need therefore to have obtained this advice by 31 May 2015 if they do not have it already.

Trustees with an ABC arrangement should bear in mind the need to value the arrangement annually and before the next certification deadline of 5pm on 31 March 2015. Trustees with existing parent company guarantees that they intend to certify for PPF levy reduction purposes should consider whether they can re-certify in 2015 based on the new certification requirements.

Sally MacCormick

Richard Evans

April 2015 DC flexibilities: legislation laid before Parliament

In October, the Government laid the Taxation of Pensions Bill (the **"Bill"**) before Parliament. The Bill will put in place the tax-related aspects of the changes announced in the 2014 Budget under which, from April 2015, members with defined contribution (**"DC"**) benefits (meaning money purchase or cash balance rights) will be able to draw down all their benefits as cash from age 55 if the trustees decide to allow this.

Background

The 2014 Budget announced that the restrictions on drawdown of pension benefits would be removed, so as to let members draw down all their DC benefits as cash from age 55 and effectively removing the requirement to annuitise. The current tax-free cash would continue to be available and members would pay tax on amounts drawn down above the tax-free cash limit as extra income, even where they withdrew all their benefits. (Currently a 55% tax charge applies if a member does this.)

Ways of taking DC benefits from April 2015

The Bill introduces two new ways for members to take their DC benefits at age 55 from 6 April 2015:

- Schemes will be able to pay a new type of authorised lump sum, called an uncrystallised funds pension lump sum, which is effectively a cash lump sum comprising all or part of a member's uncrystallised DC benefits. 25% of this sum will be tax-free and the remainder will be taxed at the member's marginal rate. There will be no limit on the number of such lump sums which can be paid to a member provided that they are paid from a member's uncrystallised DC benefits.
- Members will be able to designate their DC benefits as flexi-access drawdown funds, which will allow them to make as many uncapped withdrawals as they wish from those funds. (The member can still later use those funds to buy an annuity.) At the time that the member designates benefits as flexi-access drawdown funds, he or she will also be able to take a tax-free pension commencement lump sum. No additional tax-free cash will be payable if the member later uses some of the flexi-access drawdown funds to buy an annuity.

As now, members will still be able to use their DC funds to buy an annuity, to take a scheme pension and to exchange their benefits for a lump sum under the small lump sum rules. However, it will no longer be possible for a member to exchange DC benefits for a trivial commutation lump sum.

Statutory override

The Bill will change the ways in which schemes can allow members to access their DC benefits under the tax rules, but it will not force schemes to offer these new options. What members can do with their DC benefits in practice will depend on what their schemes allow. However, it seems that schemes will not actually have to amend their rules to allow the options. Instead, trustees will have a statutory power, but not a statutory duty, to make all the new types of payment, including payments from flexi-access drawdown funds, pension commencement lump sums in connection with a designation of flexi-access drawdown funds, and uncrystallised funds pension lump sums. The statutory power contains no requirement for employer consent to be obtained, nor does it include any express power for the trustees to recharge any additional administration costs to the member. It is not clear how trustees are expected to approach exercising this power if they come under significant member pressure to allow additional flexibility.

Treatment of existing drawdown arrangements

The existing rules about capped drawdown and the minimum income requirement for flexible drawdown will not apply to benefits designated for flexi-access drawdown on and after 6 April 2015. Funds held by members who took flexible drawdown before 6 April 2015 will be converted automatically into flexi-access drawdown funds. Members who took capped drawdown before 6 April 2015 will be able to re-designate their

funds as flexi-access drawdown funds with the scheme administrator's consent. In addition, if a member who has taken capped drawdown makes a withdrawal which breaches the capped drawdown limit, his or her drawdown funds will be converted automatically into flexi-access drawdown funds.

Changes to the annuity rules

The current rule which says that an annuity generally cannot decrease while in payment will not apply to new annuities from April 2015.

In addition, from April 2015, members with DC benefits will no longer suffer a tax penalty if the scheme provides them with an annuity without first offering them the opportunity to select the insurer (known as the open market option). (Separate legislation is expected to require schemes to offer an open market option, but – not unreasonably – it will be the scheme and not the member that is penalised if this requirement is breached.) Lifetime annuities with a guarantee period of more than 10 years will also be possible. However, where annuities are bought, they must still be bought from an insurance company and (in the case of a lifetime annuity) must be payable for life.

Changes to the trivial commutation and small lump sum rules

The age from which small defined benefit (**"DB"**) or DC pensions can be exchanged for cash of up to £10,000 under the small lump sum rules will be lowered from 60 to 55, as will the age at which a DB member's pension can be commuted for a trivial commutation lump sum (i.e. where a member's aggregate rights across all schemes are valued at less than £30,000).

In addition, the maximum amount of benefits which can be exchanged for a trivial commutation lump sum death benefit will be increased to £30,000 from 6 April 2015 to mirror the change made to the trivial commutation lump sum limit earlier this year.

Changes to the annual allowance regime

The annual allowance for future DC pension saving will reduce to £10,000 (the **"DCAA"**) where a member:

- takes an uncrystallised funds pension lump sum;
- accesses funds under flexi-access drawdown (the DCAA will not be triggered by a member designating funds as flexi-access drawdown funds or taking a pension commencement lump sum unless accompanied by a withdrawal of flexi-access drawdown funds); or
- buys a lifetime annuity other than in prescribed circumstances (as yet, the Government has not confirmed what the prescribed circumstances will be).

(The DCAA is triggered in certain other circumstances which are unlikely to affect the majority of members.) There are complicated rules on how the DCAA will interact with DB savings and the standard annual allowance of £40,000 and on how it will apply to savings under hybrid arrangements set up from 14 October 2014.

The Bill imposes a wide range of new information provision obligations on scheme administrators with respect to the new DCAA.

Changes to tax charges on death

The Bill amends the tax charges payable where a member dies with unused drawdown and DC funds with effect from 6 April 2015. Members will be able to nominate one or more beneficiaries to whom those funds will be passed on their death.

- Where the member dies before age 75, the beneficiary will not pay tax on the funds whether the funds are taken as a single lump sum or via drawdown.
- Where the member dies after age 75, the beneficiary can take the funds via drawdown, in which case the beneficiary will pay tax on the funds at his or her marginal rate. Alternatively, the beneficiary can take the funds as a single lump sum in which case he or she will pay tax at 45% on the funds (the Government intends to reduce this to the beneficiary's marginal rate of tax from the 2016/2017 tax year).

Comment

DC schemes will need to consider the extent to which they wish to offer the new flexibilities to members. The permissive statutory override does not allow schemes to recover any additional costs of offering the flexibilities from members, nor does it require schemes to obtain employer consent, despite the fact that trustees will be able to offer options that might have material administrative costs.

Whether or not schemes intend to offer the new flexibilities, they will need to start planning well ahead of April 2015 what changes they will need to make to scheme processes and administration in light of the reforms – for example to reflect the new DCAA information provision requirements.

The Pension Schemes Bill that is currently before Parliament is in the process of being amended to implement other aspects of the April 2015 reforms, such as changes to the transfer rules and the "guidance guarantee" whereby members with DC benefits will have a right to free guidance at retirement.

Ian Wright

DC schemes: big changes to governance in the pipeline too

The Department for Work and Pension (the **"DWP"**) has published a so-called Command Paper confirming its proposals for governance standards and charging restrictions in workplace defined contribution (**"DC"**) schemes. It also contains draft regulations for consultation which implement the governance changes and charging restrictions. The consultation closed on 14 November 2014. The regulations are expected to come into force in April 2015.

Requirement to appoint a chair and publish a chair's statement

The Command Paper states that the Government will legislate to require all registered pension schemes (other than single member schemes and life cover-only schemes) that provide money purchase benefits except by way of AVCs to have a chair of trustees. In addition to the usual duties as a trustee, the chair will have a separate duty to sign off an annual statement (to be called the **"Chair's Statement"**). The content of the Chair's Statement will be set out in legislation (see below). The Chair's Statement will form part of a scheme's annual report and must be made available on request to members, prospective members and beneficiaries. It will also be subject to audit. In particular, its contents will come within the requirement imposed on auditors by s70, Pensions Act 2004 to whistle-blow to the Pensions Regulator (the **"Regulator"**) in certain circumstances.

Additional requirements

In addition, the Government will legislate to:

- Require trustees to ensure that default funds (i.e. the investment option that a member is automatically put into if he or she does not select an alternative) are designed in members' interests. Specifically, trustees will have to prepare a statement including a description of the default fund or funds offered by their scheme, with a clear statement of the aims, objectives and policies in relation to investments, and an explanation of how these are in the best interests of the scheme's membership. The statement will have to be included in the Chair's Statement.
- Require "*core scheme financial transactions*" (including the attribution of contributions to the relevant funds) to be processed "*promptly and accurately*" (there is deliberately no definition of what "promptly and accurately" means). The Chair's Statement must explain how trustees have satisfied themselves that this requirement is met.
- Require trustees to review their default strategy and the underlying investment funds at least once every three years, or immediately following a significant change in investment strategy or a significant change in the demographics of scheme membership, and to report the most recent review in the Chair's Statement.
- Require trustees to calculate the charges and transaction costs borne by members and assess the extent to which they provide good value for members, and to report this in the Chair's Statement.
- Require the Chair's Statement to include an assessment of how the combined knowledge and understanding of the trustees, together with the advice that is available to them, enables them properly to exercise their functions as trustees.
- Override any provision in a scheme's rules restricting the choice of who provides administration, fund management, advisory or other services to it. Trust deeds will still be able to restrict the investments which trustees can make – although that power is itself curtailed by the operation of ss34-36, Pensions Act 1995.

The Command Paper also proposes legislation in relation to various aspects of the trusteeship of master trusts; requires providers of workplace personal pensions to set up investment governance committees to oversee the value of the schemes which they supervise; and makes clear that administrators will not have to be accredited.

Charges

There will be a cap on the charges that can be applied by the default fund in an automatic enrolment scheme. The cap will only apply where a member has monies invested in the default fund of a scheme which is a "qualifying scheme" under the automatic enrolment legislation on or after April 2015. This means that it will not apply where a DC scheme is one which has never been used for automatic enrolment. It also means that the cap will not apply to monies that are invested in a DC automatic enrolment scheme, but not in that scheme's default fund.

Under the cap, the sum of all charges levied in a year cannot exceed 0.75% of the value of the assets in the member's DC pot in that year. The cap will not include "transaction costs" – the variable costs associated with buying or selling the underlying investment instrument.

The Command Paper (and draft regulations) recognise that there are many different charging structures, and the draft legislation allows for this. The draft legislation also makes provision for where charges exceed the cap because of exceptional events, and allows for a transition period of six months from the introduction of the cap (expected to be 6 April 2015) during which time schemes will be able to have default funds in which the charges exceed the cap.

Timetable

The legislation implementing the changes is proposed to be in force on 6 April 2015, with some aspects being phased in over 2015 – 2016.

Comment

The legislation in this Command Paper has been well signposted and should not come as a surprise. The Regulator has issued a press release acknowledging that there has been a lot of change in the DC space and promising new guidance "*as soon as possible*". Hopefully the Regulator will use the opportunity to bring the code of practice on DC schemes in line with the proposed legislation so that trustees are not expected to comply with two somewhat different DC regimes.

Beth Brown

Andrew Block

Short service refunds from DC schemes: abolition date announced

The Department for Work and Pensions (the **"DWP"**) has announced that short service refunds from defined contribution (**"DC"**) occupational pension schemes will be abolished from October 2015.

Background

At present, where a member leaves a DC occupational pension scheme with between three months' and two years' pensionable service, he or she is entitled to receive either a cash transfer sum or a refund of his or her contributions (a short service refund). Short service refunds are not permitted from contract-based schemes. Section 36, Pensions Act 2014 (**"s36"**), however, will abolish short service refunds from DC occupational pension schemes for members with more than 30 days' pensionable service. Section 36 has not yet been brought into force.

Abolition date

The DWP has announced that it will bring s36 into force in October 2015. The abolition of short service refunds will only affect members who join a DC occupational pension scheme on or after the date that s36 is brought into force.

The DWP is also still planning to introduce a system for the automatic transfer of small DC pension pots so that when a member leaves one DC scheme without building up a significant pension pot and then joins another DC scheme, the member's pot in the original scheme will be automatically transferred to the new scheme. However, the DWP does not yet have a firm date for bringing in these "pot follows member" requirements.

Comment

DC occupational pension schemes will need to consider what changes will be required to their administration systems to reflect the abolition of short service refunds, and in particular to deal with the transitional period from October 2015 to mid-2017 when early leavers who joined the scheme prior to October 2015 will have different rights from early leavers who joined in October 2015 or later.

Katherine Dixon

Scheme return: new questions for DB/ hybrid schemes

The Pensions Regulator (the **"Regulator"**) has recently updated the 2014 scheme return for defined benefit (**"DB"**)/ hybrid schemes to require additional information.

The Regulator has added new questions to the 2014 scheme return for DB/hybrid schemes. These will require some schemes to provide a range of additional information when completing the return, particularly about the financial assumptions used, about "Value at Risk" (**"VaR"**) calculations, and about asset-backed contribution (**"ABC"**) arrangements.

Financial assumption information for schemes in surplus

Schemes which have declared a surplus at their most recent actuarial valuation date will be required to report the discount rates used and discount rate structure, as well as the assumptions they have used regarding pay increases and inflation.

VaR information

Some trustees ask their advisers for VaR calculations. Typically, a VaR calculation is an estimate of the additional deficit which could arise in a scheme over a period of time, expressed in conjunction with a certain level of probability that it will occur. VaR calculations are typically undertaken by the scheme actuary or investment consultant.

Schemes are not required to obtain VaR calculations. However, where they have been obtained, the Regulator is seeking the VaR calculation carried out at the most recent actuarial valuation date, the date of calculation, the liability basis for the calculation, the percentile at which the VaR has been calculated, and the period over which the VaR has been modelled. Where VaR information cannot be provided, the Regulator has said that it will assess the scheme's investment risk by reference to the allocation of the scheme's assets between different asset classes without allowing for any hedging that may be in place in respect of interest rates, inflation and other risks.

ABC arrangements

Schemes which have entered into an ABC arrangement will be required to provide information regarding the structure, funding, valuation and terms of the arrangement. This includes the value of the scheme's interest in the ABC as at the most recent actuarial valuation date, the types of underlying asset and their value, annual payment information, and information on how the scheme's interest in the ABC has been funded.

Comment

Additional questions were also added to the 2014 scheme return for defined contribution (**"DC"**) schemes earlier in the year, and a DC scheme return checklist and example form of the 2014 DC scheme return were published[1].

The changes to the scheme return for DB/hybrid schemes reflect the Regulator's desire for a better understanding of the risk characteristics of the DB pension landscape in the UK. The Regulator has similarly published a DB scheme return checklist and an example form of the 2014 DB/hybrid scheme return[2]. Trustees should consult their scheme actuaries and advisers when completing the returns.

Bo Young Park

1 www.thepensionsregulator.gov.uk/trustees/dc-scheme-return.aspx
2 www.thepensionsregulator.gov.uk/trustees/db-hybrid-scheme-return.aspx

"Fit and proper person": guidance on the new test for trustees

Since 1 September 2014, HM Revenue & Customs (**"HMRC"**) has been able to refuse to register a scheme or to de-register an existing scheme where it believes the scheme administrator – by which it normally means the trustees – is not a "fit and proper person". HMRC has now published final guidance on what a "fit and proper person" means.

Background

HMRC's new power is one of a number that it was given in the 2014 Budget to combat pensions liberation (the other powers took effect from March 2014). The Government's aim is to ensure that pension schemes are set up and run by appropriate people.

The "fit and proper person" requirement applies to the scheme administrator for Finance Act 2004 purposes. For this purpose, the "scheme administrator" will generally be the scheme trustees as opposed to the party who actually carries out the day to day administration of the scheme.

The guidance

There is no statutory definition of a "fit and proper person". HMRC's guidance says that a scheme administrator is likely to be a fit and proper person *"if they are familiar with, and capable of competently performing, the scheme administrator's responsibilities and there is nothing in their past behaviours to suggest they should not be responsible for the financial management of the pension scheme"*. HMRC will assume that a scheme administrator meets the requirement unless it obtains information to suggest otherwise. Where a scheme administrator is a corporate body, HMRC will consider whether the directors and individuals managing the corporate body are fit and proper persons.

If HMRC finds cause to investigate a scheme administrator, the registration of a new scheme will be frozen, and no confirmation will be given about an existing scheme's registered status. HMRC's guidance includes a list of factors that may indicate that an administrator is not a fit and proper person. Many of these factors are unsurprising e.g. previous involvement in pensions liberation or tax avoidance schemes. One of the more interesting factors is having insufficient working knowledge of pensions and pensions tax legislation and not employing an adviser with this knowledge; HMRC recognises that an employer setting up a pension scheme may not have detailed knowledge, but if this is the case, it expects a knowledgeable adviser to be appointed.

HMRC has power to request information from the scheme administrator or other persons. It warns that investigations may take up to six months to complete. The stakes may be high; if a scheme is de-registered, a 40% de-registration charge is applied to the scheme's assets, payable by the scheme administrator, although HMRC's decision can be appealed.

Comment

The new powers strengthen HMRC's position in the fight against pensions liberation. The guidance demonstrates the flexibility that HMRC has when exercising its powers. Hopefully this will enable HMRC to focus its efforts on and help stem the creation of sham schemes. Well-run schemes that take regular advice should have no concerns with the new legislation.

Olivia Caird

Pensions Regulator: Lehman Brothers settlement

The Pensions Regulator (the **"Regulator"**) has reached an agreement with the six Lehman Brothers companies issued with financial support directions (**"FSDs"**) in 2010, settling their liability under those FSDs.

Background – the Regulator's moral hazard powers

In certain circumstances, the Regulator's moral hazard powers under the Pensions Act 2004 allow it to issue FSDs to one or more parties associated with the sponsoring employer of a defined benefit (**"DB"**) scheme. A party issued with an FSD is required to secure that the scheme has financial support. If an FSD is not complied with, the Regulator has the power to issue a contribution notice to the party requiring that they pay a specified amount of money into the scheme.

The FSDs issued to Lehman Brothers companies

In 2008, many companies in the Lehman Brothers group went into administration, including the principal employer of the Lehman Brothers pension scheme (the **"scheme"**). In 2010, the Regulator issued FSDs to six of these companies (the **"targets"**) as the scheme had been left without ongoing funding support.

A number of issues have been tested in court as a result of legal challenges brought by the administrators of the targets, including the question of the maximum amount that the Regulator can recover under a contribution notice issued following non-compliance with an FSD. In this case, known as the *Re Storm Funding* case, the High Court decided that the aggregate amount recovered under contribution notices issued to a number of targets in respect of the same scheme may exceed the value of the section 75 debt owed to the scheme.

Terms of the settlement

The targets have agreed to pay the scheme trustees an amount which will enable the trustees to buy out member benefits in full. This will prevent the scheme from entering the Pension Protection Fund (the **"PPF"**). The buy-out figure was estimated at £184m as at 30 June 2014. The Regulator and the targets have also agreed that the decision in the *Re Storm Funding* case will not be appealed.

Comment

In a separate use of its moral hazard powers, the Regulator has also recently announced a settlement in relation to an MG Rover Group pension scheme. Having issued a warning notice of its intention to issue an FSD to a company which bought a portfolio of vehicle finance agreements with former customers of the MG Rover Group, the Regulator agreed a settlement under which that company will pay £8m into the scheme. This will enable the scheme to wind up outside the PPF. The Regulator will no longer pursue an FSD against the company.

These settlements show that the Regulator can use its moral hazard powers successfully to protect members' benefits and to keep schemes out of the PPF. The settlements are particularly beneficial for those members who might have received a reduction in their benefits if the schemes had entered the PPF.

Devora Weaver

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**

  9 December 2014
  24 February 2015
  19 May 2015
  15 September 2015
  1 December 2015

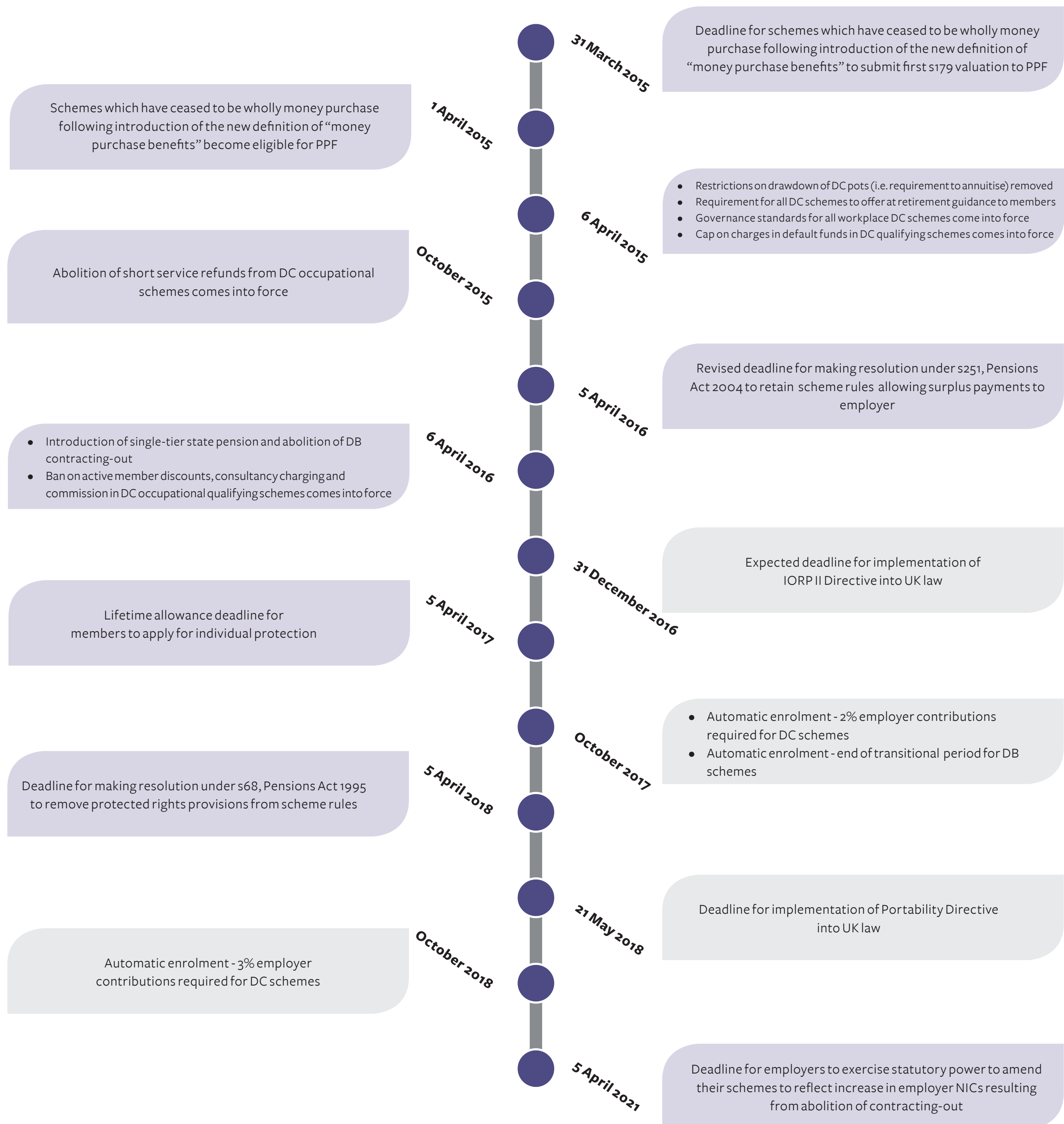
  Our Foundation Course aims to take trustees through the pensions landscape and the key legal principles relating to DB funding and investment matters, as well as some of the specific issues relating to DC schemes, in a practical and interactive way..

- **Trustee Building Blocks Classes**

  16 June 2015 – topic to be confirmed
  17 November 2015 – topic to be confirmed

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

Dates and deadlines



Key:

Important dates to note

For information

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