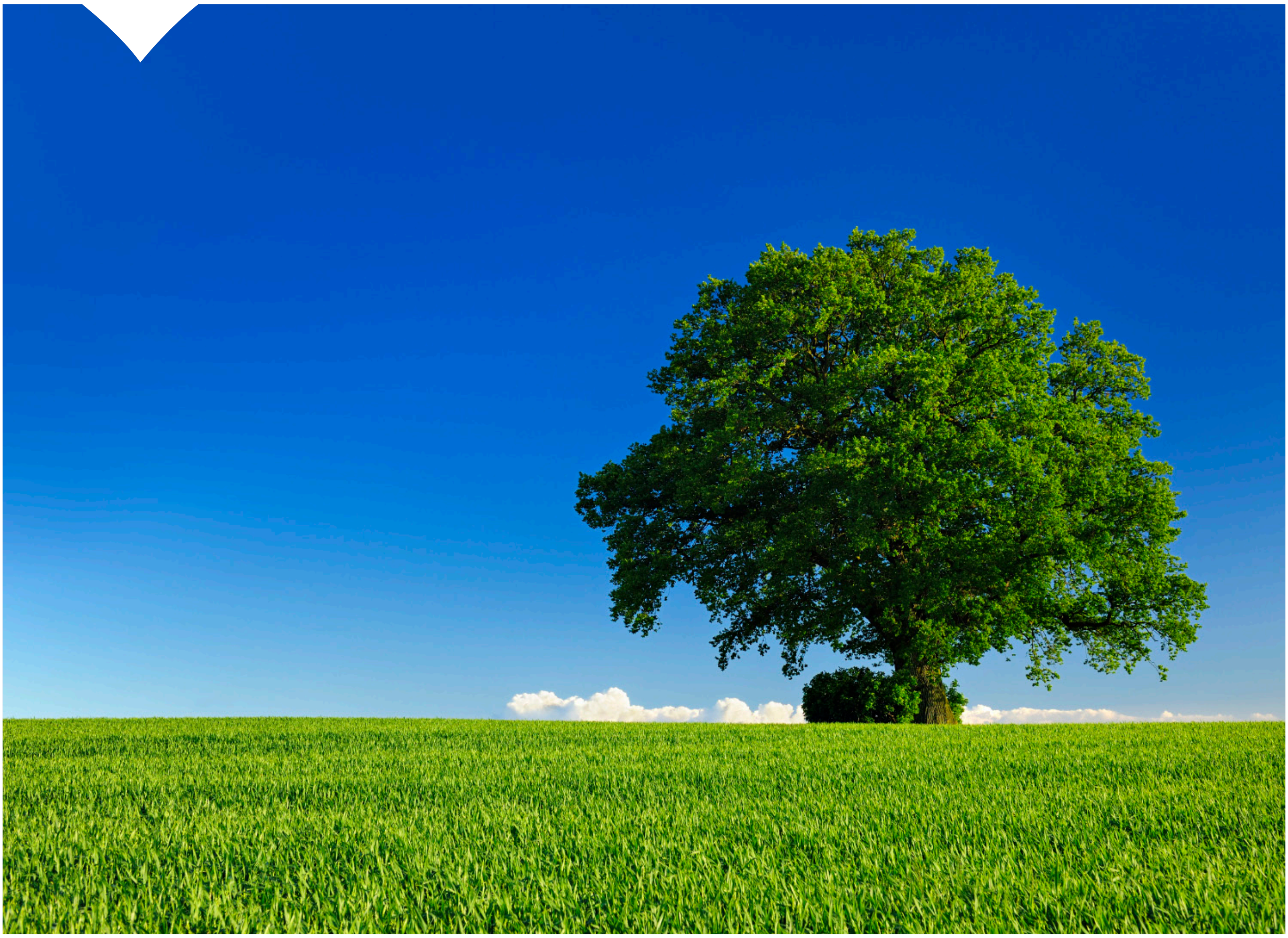
MAYER • BROWN

August 2015

Trustee Quarterly Review

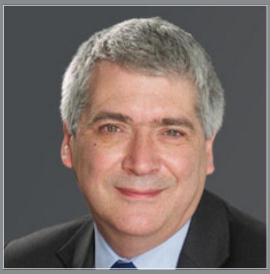
Quarterly update for pension scheme trustees



Introduction

Welcome to the August 2015 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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Summer Budget – yet more pensions tax changes

In the Summer Budget, the Chancellor announced a further raft of pensions tax changes, including the implementation of the Conservative election manifesto pledge to reduce pensions tax relief for high earners. The Chancellor also announced consultations on whether and how the pensions tax system should be reformed, and on how to improve the pension transfer process.

Tax relief for high earners

From 6 April 2016, tax relief on pension contributions will be reduced for individuals with "adjusted income" of over £150,000. This will be achieved by reducing the annual allowance by £1 for every £2 over the £150,000 threshold, down to a minimum of £10,000. "Adjusted income" is essentially income plus the value of any employer pension contributions. A further "baseline" threshold will apply whereby individuals whose unadjusted income (i.e. excluding employer pension contributions) is under £110,000 will not generally be subject to the reduced annual allowance.

In order for the new system to function correctly, pension input periods will need to be aligned with the tax year. (This will be the case for all individuals, whether or not they are likely to be subject to the reduced annual allowance.) Complicated transitional measures will therefore be put in place to achieve this whilst ensuring that individuals receive the correct amount of tax relief for the period up to 5 April 2016.

Pensions tax reform

The Government has launched a consultation on whether and how the pensions tax relief system should be reformed. The consultation does not make any concrete proposals but, among other things, ask for views on whether an alternative pensions tax system (e.g. where pension contributions are taxed rather than pension payments) would be likely to result in greater engagement in pension saving. The consultation runs until 30 September 2015.

Transfers

The Government is also consulting on how to improve the pension transfer process, including the issue of early exit charges. The consultation asks for views on how to make the transfer process more efficient, and on the impact on the transfer process of the requirement for members to take independent financial advice before transferring DB benefits to a DC scheme.

The consultation also asks for evidence on the level and types of exit charges, and for views on what would constitute an excessive or unfair early exit charge. If there is clear evidence of excessive early exit charges for people aged 55 or over, the Government has identified three possible means of addressing the issue: a legislative cap on all such charges (other than market value adjustments and terminal bonuses); a flexible legislative cap applicable in certain circumstances; and asking the pensions industry to develop a voluntary approach to restricting such charges. The Government is also interested in any alternative suggestions that consultation respondents may have. The consultation runs until 21 October 2015.

Other announcements

A number of other pensions-related measures were announced or confirmed in the Summer Budget.

- As previously announced, the lifetime allowance will be reduced to £1m from 6 April 2016. Fixed and individual protection will be available as they were for the 2014 reduction in the lifetime allowance, but HMRC is considering whether to dispense with the requirement to register for such protection by a set deadline.
- As previously announced, the 45% tax charge on certain lump sum death benefits will be reduced to the recipient's marginal tax rate from 6 April 2016.
- The Pension Wise guidance service will be extended to people aged 50 and over.
- A secondary annuity market will be introduced, but its implementation will be delayed until 2017.

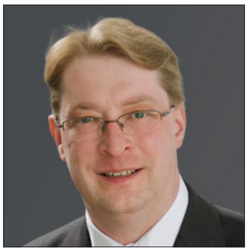
- The Government will consult on tackling the use of unfunded employer-financed retirement benefit schemes to obtain tax advantages for employee remuneration.
- The Equitable Life Payment Scheme will be closed to new claims on 31 December 2015.
- The Government will "actively monitor the growth of salary sacrifice schemes that reduce employment taxes and their effect on tax receipts".

Comment

While many in the pensions industry might have been hoping for a quiet Budget on the pensions front, most knew this was unlikely given the Conservatives' election manifesto pledge to cut pensions tax relief for high earners. The consultation on pension transfers and the possibility of a cap on exit charges are likewise not unexpected.

What will come as a surprise, however, is the consultation on potential reform of the pensions tax system. Whilst the "exempt-exempt-taxed" model has been subject to a range of adjustments, it has never previously been suggested by the Government that this model should be abandoned in favour of an alternative. It remains to be seen whether the consultation leads to any actual change and, if it does, whether that change amounts to further adjustment of the current model or a whole scale reform of the system.

In the meantime, the alignment of pension input periods with the tax year will be complex both to administer and to explain to members. With 6 April 2016 also bringing in the abolition of contracting-out, schemes will need to factor the annual allowance changes into their scheme planning as soon as possible to ensure that they are suitably prepared.



Ian Wright

DB funding – Regulator's annual statement

The Pensions Regulator has published its 2015 annual funding statement for DB schemes (the **"2015 statement"**).

Background

The Regulator is responsible for overseeing DB schemes' compliance with the statutory funding regime. Since 2012, the Regulator has published a statement each year providing guidance for trustees and employers of schemes with a valuation date falling in the year from the preceding September to the following September.

The 2015 statement

The 2015 statement is targeted at schemes with valuation dates between 22 September 2014 and 21 September 2015. As the first funding statement following the adoption of the revised code of practice on DB scheme funding (the **"code"**), it reinforces the key principles outlined in the code and explains how these can be applied in current market conditions. The importance of a collaborative approach between trustees and employers in managing scheme funding is emphasised.

The key points in the 2015 statement include the following:

- *An integrated approach to managing risk:* The level of risk taken must be appropriate to the circumstances of each scheme and employer. Trustees are encouraged, in discussion with employers, to undertake contingency planning and monitoring.
- *Market conditions and impact on scheme funding:* Although all major asset classes have performed well, many schemes will have larger funding deficits due to the impact of falling interest rates and the failure to fully hedge against this risk.
- *Investment returns:* Given the uncertainty about future market conditions, trustees must carefully consider the potential impact on their scheme of different scenarios for investment returns. The Regulator anticipates that most schemes will set funding strategies based on lower investment returns than at their last valuation.
- *Managing deficits in current market conditions:* Schemes with additional capacity to take risk should be able to address their deficit through a modest extension to their recovery plans, a modest increase in deficit repair contributions, and/or changing their investment return assumptions. Schemes with a more limited capacity to take additional risk should seek higher deficit repair contributions where affordability permits and the employer's sustainable growth plans will not be adversely affected.
- *Affordability and sustainable growth:* Where the employer's affordability is constrained, trustees should undertake a higher level of due diligence on what the employer can afford (in light of any sustainable growth plans), and put in place strategies for managing the greater risks that a lower level of deficit reduction contributions brings.
- *Post-valuation experience:* Trustees should understand the impact of worsening or improving market conditions on the scheme's position, and should actively monitor the impact of these conditions post-valuation and take action where necessary.
- *DB to DC transfer values:* In light of the April 2015 reforms, trustees should seek advice on the implications of changes to the number of members taking transfers on the scheme's funding assumptions and long-term membership trends.

The Regulator has confirmed that it will continue to use a broad range of risk indicators to identify schemes with which to engage further. When the Regulator decides to engage with a scheme, it seeks to understand the trustees' decisions in relation to specific risks and the quality of their decision-making process.

In addition, the Regulator plans to publish additional practical guidance on an integrated approach to risk management, covenant assessment and setting an investment strategy to complement the code.

Comment

Almost a year after the code came into force, the 2015 statement is a useful reminder for schemes of the approach to scheme funding that they should be adopting. It is also a helpful indicator of the Regulator's views on how trustees should approach funding in light of current market conditions.

Bo Young Park

Changing pension terms by contractual agreement – the BBC Pension Scheme case

The High Court has held that the BBC did not breach its implied duties of trust and confidence and of good faith in seeking to impose a cap on pensionable pay by contractual agreement with employees rather than by amendment of the scheme rules.

The contractual change

This case related to a Mr Bradbury, who was a member of the BBC Philharmonic Orchestra and a member of the final salary section of the BBC Pension Scheme.

The scheme had a large deficit and, to reduce its liabilities, the BBC decided to limit the extent to which future pay increases for members of the final salary section would be pensionable. This was achieved by a contractual agreement with members, rather than by amending the scheme rules. Members were offered future pay increases on the condition that the member first agreed that only the first 1% of the increase would be pensionable. If the member did not agree to that condition, the member could not continue in the final salary section of the scheme – they would have to either join a career average section or opt out of the scheme altogether and join a DC arrangement.

Case law has established that an employer can amend the terms of member benefits under an occupational pension scheme by contractual agreement with the employees whose benefits will be affected. However, the employer is subject to implied duties of trust and confidence and of good faith in its dealings with its employees, which also apply in the pensions context (the **"implied duties"**).

Mr Bradbury's complaint

Mr Bradbury had complained to the Pensions Ombudsman that the BBC's actions in seeking to impose the pensionable pay cap via the contractual route breached the BBC's implied duties. The Ombudsman rejected the complaint. Mr Bradbury appealed to the High Court, claiming that the Ombudsman had failed to engage in an overall assessment of the question of whether the BBC's conduct was in breach of its implied duties.

Instead, the Ombudsman had considered each component of the BBC's conduct separately and concluded that none gave rise to a breach of the implied duties. The arguments Mr Bradbury had put to the Ombudsman were that:

- the way in which the BBC had sought to implement the cap amounted to improper coercion;
- the BBC had a collateral purpose, namely to produce a greater turnover among older staff by making the scheme less attractive to such staff;
- the 1% cap amounted to indirect age discrimination against younger members (although it was accepted that Mr Bradbury was not among the disadvantaged members); and
- the BBC had failed to consult members properly and should have consulted with the scheme trustees.

The High Court's decision

The Court agreed with the Ombudsman that the BBC had not breached its implied duties and dismissed Mr Bradbury's appeal. On the specific arguments advanced by Mr Bradbury, the Court decided that:

- *Improper coercion*: The BBC was entitled to seek to impose the cap by contractual agreement rather than rule amendment, provided that it did not breach its implied duties. Although Mr Bradbury only had limited options, the BBC did not apply improper coercion in requiring him to make a choice.
- *Collateral purpose*: The Court was satisfied that the primary purpose of the cap was to address the scheme deficit. The BBC was entitled to choose this method of addressing the deficit against any other possible methods.
- *Age discrimination*: The Ombudsman had been entitled to conclude that his obligation was not to assess the overall discriminatory impact of the cap, but rather whether the BBC had breached its duties to Mr Bradbury. Even if it was established that the cap had an unlawful discriminatory effect against members other than Mr Bradbury, this did not mean that the BBC had breached the implied duties it owed to Mr Bradbury.

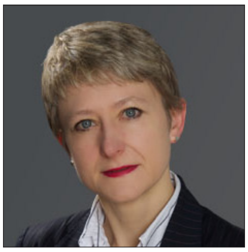
- *Consultation*: The Ombudsman had been entitled to conclude that the consultation had been carried out properly and that it was not necessary to consult the trustees.

In dismissing Mr Bradbury's appeal, the judge said that, once the Ombudsman had decided that none of the individual factors raised by Mr Bradbury amounted to a breach of the BBC's implied duties, it would have been surprising if the Ombudsman had concluded that the BBC's overall conduct amounted to such a breach. In fact, the judge went beyond that and said that such a conclusion would have been one which no reasonable pensions ombudsman could have reached.

The Court's own conclusion was that the overall conduct of the BBC did not give rise to a breach of the implied duties.

Comment

This decision will be welcomed by employers seeking to amend the terms of their employees' pension benefits via contractual agreement rather than by rule amendment. However, employers do still need to be aware, when planning benefit changes, of any "reasonable expectations" that their previous conduct in relation to their pension scheme may have created. Employers who have introduced a pensionable pay cap may also be disappointed that the Court left open the question of whether such a cap might involve indirect age discrimination.



Beverly Cox

Pension Protection Fund Ombudsman - two further cases decided against trustees

Recent decisions by the Pension Protection Fund Ombudsman (the "**PPFO**") have confirmed that the PPF may apply "hard-edged" rules when calculating PPF levies, and that strict compliance with its annual determination is required for recognition of contingent assets.

Rules-based levy system

A new pension scheme was set up in 2007 which was to remain without any substantial assets or liabilities for part of the 2008/09 levy year until a bulk transfer was received. The trustees asked the PPF if they could delay submitting the scheme's first s179 valuation until the bulk transfer was received so as to avoid having to incur the costs of submitting a "zero" valuation. The PPF said in an email that they "would not be minded to take any action in this case in relation to the non-submission of the s179 valuation". The PPF also confirmed that they have a "discretion to charge a nil levy for some new schemes" and that it is "likely that this discretion would be exercised in this case for 08/09". On that basis, the scheme did not submit a s179 valuation before the bulk transfer was received.

In April 2012, the PPF issued the scheme with a levy invoice, including £75,187 for the risk-based levy for 2008/09. The trustees referred the case to the PPFO on two grounds. Firstly, the trustees argued that they had relied on the representations in the email from the PPF to their detriment as they did not submit a s179 valuation. Secondly, the trustees argued that the 2008/09 levy invoice was invalid because it was issued after that levy year.

The PPFO decided against the trustees on both counts. The PPFO decided that the email from the PPF did not contain a clear and unambiguous representation that there would be no charge for the 2008/09 risk-based levy. He also decided that there is no time limit within which the PPF must issue an invoice in respect of a particular levy year.

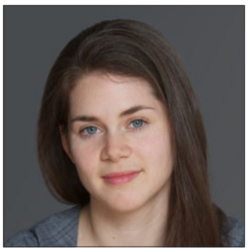
Strict compliance with PPF determination

A scheme attempted to re-certify a type B(ii) contingent asset (security over land) with the PPF in order to reduce its risk-based levy. The trustees had certified the contingent asset successfully in a previous levy year, but amendments had been made to the security agreement since it had last been accepted by the PPF.

As part of the re-certification process, the trustees had to confirm that there were no prior or "pari passu" (i.e. equal ranking) security interests affecting the land. According to the PPF's annual levy determination, this confirmation should have been made on the basis of a legal opinion dated after the registration of the charge so that the ranking of interests was fixed when the opinion was given. In this case, the legal opinions provided to the PPF pre-dated the registration of the security agreement and so the PPF rejected the contingent asset. The contingent asset was rejected even though it was a requirement of this particular security agreement that a legal opinion was obtained before it was signed.

Comment

These decisions demonstrate the importance of observing to the letter the (extensive) small print in the PPF's levy determinations. If trustees seek any assurances from the PPF about the levy calculation outside the formal submission of forms, this should be clearly and properly documented. Trustees should also seek advice as to the extent to which communications from the PPF can be relied upon.



Devora Weaver

In other news...

Abolition of contracting-out – new regulations published

Following a consultation last year, the Government has laid regulations before Parliament setting out the rules with which schemes that were formerly contracted-out will need to comply when contracting-out ends next April. Broadly, they mean that aspects of the current contracting-out regime, for example restrictions on changes to accrued contracted-out rights, will still apply to those schemes. (Separate regulations issued in March 2015 dealt with a statutory power for employers to reduce future accrual and/or increase member contributions when contracting-out ends, to reflect the increase in employer National Insurance contributions.)

The Government has also published an accompanying consultation response which, among other things, confirms that the Government does not intend to give schemes which provide benefits that are integrated with the current basic state pension (such as bridging pensions) a statutory power to amend their rules to reflect the replacement of the basic state pension with the new single tier flat rate state pension.

We will be publishing a fuller update on the regulations and the implications of the abolition of contracting-out for schemes and employers shortly.

Don't forget – employer surplus payment resolution deadline

5 April 2016 is the deadline for schemes to pass a resolution preserving any power in their rules to make a payment of surplus to an employer whilst the scheme is ongoing. If a resolution has not been passed by this date, any such powers in scheme rules will become ineffective.

The requirement to pass a resolution does not apply to powers to make payments of surplus to an employer on a winding-up of the scheme.

Corporate directors of trustee companies

The Small Business, Enterprise and Employment Act 2015 imposes a ban on companies acting as directors of other companies. Many pension schemes have trustee companies which have directors that are themselves companies. Typically this happens where a professional trustee company has been appointed as one of the directors of a pension scheme's trustee company. The ban could therefore have serious implications for such schemes and for professional trustees.

However, the Government has recently announced that the ban will not come into force until 2016. Also, in late 2014, the Government consulted on proposed exceptions to the ban. One of those would have allowed a company to be a director of a pension scheme's trustee company. As yet, no response to this consultation has been published, but it looks hopeful that there will be an exception of the type proposed, and that the ban will therefore not cause problems for the pensions industry when it does come into force.

Changing early retirement policies

The High Court has decided that, when adopting a new policy about when it will consent to early retirement, an employer did not have to give notice to members of its intention to adopt the new policy. However, it did need to inform members that a new policy had been adopted, and the policy was not effective until it had done so.

EMIR: exemption from central clearing requirements

The European Commission has published a draft regulation extending the exemption for pension schemes from the central clearing requirements under the European Market Infrastructure Regulation for a further two years.

DC scheme return – new questions

The scheme return for DC schemes has been updated for 2015 to include questions:

- confirming the scheme's compliance with the charges cap (where applicable);
- confirming either the name of the trustee chair or that the scheme is exempt from the requirement to appoint a chair; and
- confirming whether the scheme employer has used the scheme to automatically enrol employees or as a qualifying scheme in respect of existing employees since 6 April 2015.

Pensions Ombudsman – redress for non-financial injustice

The Ombudsman has published a factsheet to provide guidance on its approach to redress for non-financial injustice (such as distress and inconvenience). The Ombudsman's usual starting point for awards will be £500 or more, and in most cases, awards will range from £500 to £1,000, although higher awards may sometimes be made. If the non-financial injustice is not significant, no award is likely to be made.

Katherine Dixon

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**

  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**
  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

1 October 2015

Abolition of short service refunds from DC occupational schemes comes into force

5 April 2016

Revised deadline for making resolution under s251, Pensions Act 2004 to retain scheme rules allowing surplus payments to employer

6 April 2016

- Introduction of single-tier state pension and abolition of DB contracting-out
- Ban on active member discounts, consultancy charging and commission in DC occupational qualifying schemes comes into force
- Lifetime allowance reduces to £1m
- Introduction of tapering of annual allowance for individuals with "adjusted income" of £150,000 or more
- Alignment of pension input periods with tax year
- Tax charge on certain lump sum death benefits reduces from 45% to recipient's marginal tax rate

October 2016

Proposed introduction of automatic transfer system for small DC pots

2017

- Government to review level and scope of DC charges cap
- Proposed introduction of secondary annuity market

5 April 2017

Lifetime allowance deadline for members to apply for individual protection

30 September 2017

Automatic enrolment – end of transitional period for DB schemes

1 October 2017

Automatic enrolment - 2% employer contributions required for DC schemes

5 April 2018

Deadline for making resolution under s68, Pensions Act 1995 to remove protected rights provisions from scheme rules

6 April 2018

CPI indexation of lifetime allowance to be introduced

21 May 2018

Deadline for implementation of Portability Directive into UK law

1 October 2018

Automatic enrolment - 3% employer contributions required for DC schemes

5 April 2021

Deadline for employers to exercise statutory power to amend their schemes to reflect increase in employer NICs resulting from abolition of contracting-out

Key:

Important dates to note

For information

About Mayer Brown

Mayer Brown is a global legal services provider advising clients across the Americas, Asia and Europe. Our geographic strength means we can offer local market knowledge combined with global reach. We are noted for our commitment to client service and our ability to assist clients with their most complex and demanding legal and business challenges worldwide. We serve many of the world's largest companies, including a significant proportion of the Fortune 100, FTSE 100, DAX and Hang Seng Index companies and more than half of the world's largest banks. We provide legal services in areas such as banking and finance; corporate and securities; litigation and dispute resolution; antitrust and competition; US Supreme Court and appellate matters; employment and benefits; environmental; financial services regulatory and enforcement; government and global trade; intellectual property; real estate; tax; restructuring, bankruptcy and insolvency; and wealth management.

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