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November 2015

Trustee Quarterly Review

Quarterly update for pension scheme trustees

Introduction

Welcome to the November 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 the issues covered in this edition of the Review.

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PPF levy 2016/17 – consultation on draft rules published

In September, the Pension Protection Fund published draft rules for the 2016/17 levy for consultation (the **"draft rules"**). In summary, the draft rules are very similar to the rules for the 2015/16 levy. The most significant changes are designed to simplify reporting requirements for schemes rather than to alter the levy calculation methodology. The consultation closed in October, and the final version of the 2016/17 rules will be published in December..

Maintaining stability

Last year the PPF introduced a levy framework which applies for a three year period covering the 2015/16 – 2017/18 levies (see our November 2014 Trustee Quarterly Review for details). The PPF's aim was to maintain stability in the way in which the levy is calculated over that three year period. The draft rules show that this aim is being achieved, with the PPF stating that that the rules "*will be very substantially the same as for 2015/16*". The estimated levy for 2016/17 across all schemes is £615m, which is £20m lower than the £635m figure for 2015/16.

Insolvency risk measurement

For the 2015/16 levy the PPF adopted a new approach for making its assessment of an employer's insolvency risk. The PPF sees limited need to make changes to this model for the 2016/17 levy. The PPF describes the changes being proposed as "*of an essentially limited and technical nature*". They concern improvements or clarifications of existing processes – for example, seeking to simplify the process for re-certifying mortgage exclusions for insolvency score purposes.

Asset-backed contributions

For the 2015/16 levy a new requirement was introduced for asset-backed contributions (**"ABCs"**) to be certified via a separate form if their value was to be recognised in the levy. Amongst other things, trustees had to obtain legal advice and a valuation of the underlying assets on the "insolvency basis".

As 2015/16 was the first year of the new ABC certification requirement, the PPF focussed its review of submitted certificates on whether overall its guidance had been met, rather than requiring adherence to every aspect. The PPF has noted that it may take a more rigorous approach for certificates submitted in future years.

As regards re-certification in 2016/17 of ABCs which were previously certified in 2015/16, the PPF has indicated the potential for a light touch approach which would mean, in most cases, no need to produce new legal advice and potentially an updated rather than a new valuation.

Parent company guarantees

For the 2015/16 levy a new certification requirement was introduced for parent company (and group company) guarantees, requiring trustees to certify a fixed amount that the guarantor could pay. The PPF is incorporating key elements from its guarantor strength factsheet (published in January 2015) into its guidance for 2016/17, to provide trustees with further guidance on the approach they should take to assessing guarantors.

Last man standing schemes

An associated last man standing (**"LMS"**) scheme is a multi-employer scheme with no option or requirement to segregate assets when an employer withdraws. LMS schemes have enjoyed a reduction in the levy they pay, as they are perceived to present a lower risk to the PPF. For the 2015/16 levy, a new requirement was introduced that LMS schemes could only benefit from the levy reduction where they provided confirmation that they had received legal advice supporting their LMS status.

For 2016/17 it will remain the case that only those LMS schemes which have provided this confirmation will benefit from the levy reduction. The Pensions Regulator will include this confirmation on the Scheme Return. The 2015/16 exercise brought to the PPF's attention that not all the schemes which had previously indicated that they were LMS schemes, and had benefited from a reduced levy as a result, in fact have that scheme structure. The PPF has indicated that it will re-invoice such schemes for levy arrears "*where it is economic to do so*" – noting that the category of affected schemes includes some very large schemes, for whom the levy reductions have been substantial.

Comment

For schemes which pay the PPF levy, the draft rules provide some welcome stability and contain some efforts to reduce the burdens on those schemes that will be appreciated. What will be less welcome for schemes which had previously incorrectly thought they were LMS schemes – and which had received a levy discount on that basis – is the possibility of now having to pay levy arrears in relation to that discount.

Giles Bywater

Clarification of benefits payable to same sex partners

The Court of Appeal has confirmed that, where a pension scheme gives civil partners/same sex spouses less generous benefits than opposite sex spouses for service before 5 December 2005, this difference in treatment does not breach the provisions of the Equality Act 2010 (the **"Act"**) covering discrimination on grounds of sexual orientation.

However, this decision relates only to whether different treatment breaches the Act. There are separate duties, in *contracting-out legislation*, which require contracted-out schemes to provide benefits for civil partners and same sex spouses for service from 1988 onwards, and the Court of Appeal's decision does not affect those duties.

Background

An EU Directive adopted in 2000 (the **"Directive"**) requires member states to pass legislation that prevents discrimination in the employment context on the grounds of sexual orientation. The Act implies a non-discrimination rule into UK occupational pension schemes. Amongst other things, this requires schemes to treat surviving civil partners and same sex spouses the same as opposite sex spouses for service on and after 5 December 2005, the date when civil partnerships first became possible. (As noted above, separate legislation treats civil partners/same sex spouses similarly to opposite sex widowers for contracted-out service from 1988 onwards, including giving civil partners/same sex spouses a right to a widower's GMP).

The crux of the case in the Court of Appeal was whether the carve-out in the Act for service before 5 December 2005 was consistent with the Directive, and whether the courts should effectively set it aside.

Mr Walker's case

Mr Walker joined his employer's pension scheme in 1980 and retired in 2003. He entered into a civil partnership on 23 January 2006 and later married his civil partner. Mr Walker wanted to clarify what his civil partner (later his spouse) would be paid from his pension scheme on his death.

An employment tribunal decided that the carve-out in the Act for pre-December 2005 service was contrary to EU law, and that Mr Walker's partner should get a full widower's pension for all Mr Walker's service. But this was overturned by the Employment Appeal Tribunal which decided that, although the scheme rules treated Mr Walker's partner less favourably than an opposite sex partner, this was not unlawful, because all his pensionable service pre-dated 5 December 2005. It also found that the carve-out in the Act which permits this was compatible with the Directive, as the Directive did not expressly say it had retrospective effect.

The Court of Appeal agreed and upheld the ruling of the Employment Appeal Tribunal. It said that "*conduct which was lawful when it occurred* [such as treating opposite sex partnerships more favourably than same sex partnerships in respect of service before December 2005] *cannot retroactively become unlawful*". Lord Justice Lewison noted that the UK legislation was "*expressly designed to preclude a claim such as Mr Walker's from being made*" and said that asking the Court to extend Mr Walker's partner's entitlement to relate to Mr Walker's pensionable service before December 2005 would be requiring the Court to enter into the realms of policy rather than simply interpreting the legislation as it stands. The Court of Appeal also said it was confident enough that EU law allowed the carve-out for pre-December 2005 service that it declined to refer the case to the Court of Justice of the European Union.

Comment

This decision is not surprising in that it reinforces what the legislation says. However, while trustees are not required to fully equalise benefits payable to opposite sex spouses and civil partners/same sex spouses, trustees and employers may nonetheless choose to do so.

Beth Brown

Pensions Regulator – new employer covenant guidance

The Pensions Regulator has published new practical guidance for trustees on assessing and monitoring the employer covenant. This replaces previous guidance that was published in 2010. There are familiar themes in the new guidance, for example, the importance of determining the exact legal entity responsible for the scheme's liabilities, and a focus on the employer's future ability to support the scheme. However, there are some important changes in emphasis, and the new guidance is intended to offer more practical help to trustees.

The employer covenant

The employer covenant is the extent of the employer's legal obligation and financial ability to support the scheme now and in the future. In keeping with the Regulator's latest code of practice on DB funding (published last year – see our August 2014 Trustee Quarterly Review for more details), the guidance reiterates the importance of assessing and monitoring the covenant as part of an integrated approach to investment and funding risk management. Essentially, trustees can only make informed decisions about investment and funding risks if they understand the extent of the employer's legal obligation and financial ability (and any risks to that ability) to support the scheme now and in the future.

The guidance

The Regulator suggests that, as a minimum, trustees should undertake a full covenant review at each valuation and should monitor the covenant between formal reviews so that they can take action promptly if required. One question that trustees should periodically consider is whether it is necessary to commission an external covenant assessment. The guidance contains a list of relevant factors that might support engaging a third party assessor, such as the trustees being unable to take an objective view, the trustees not having the relevant expertise, the covenant undergoing significant changes (for example due to the employer restructuring), or the scheme being highly reliant on the covenant. The guidance makes it clear that if external advice is not taken, trustees need to be comfortable that they have sufficient financial expertise and can remain objective in their assessment. If trustees decide it is appropriate to engage a third party, the guidance includes some practical pointers for drawing up a brief with an external covenant adviser.

The guidance sets out in detail how trustees should go about assessing and monitoring the covenant and makes it clear that a "desktop" review based on published or readily available historic information is likely to be of little value. However, it also promotes a proportionate approach depending on the circumstances of the scheme and the employer. It suggests factors for trustees to consider when deciding on the extent of the assessment and the frequency of monitoring, for example, an employer that is part of a large group with a complex legal and operational structure might merit a more detailed approach and more frequent review.

The guidance also contains a short section on ways to improve a scheme's security through the use of contingent assets, amendments to the scheme's balance of powers, and improvements to the scheme's priority on employer insolvency. By strengthening the employer covenant, such steps may give the trustees more flexibility in relation to the scheme's funding and investment strategy. In addition, the guidance contains some further considerations for trustees of non-associated multi-employer schemes and schemes which are supported by a not-for-profit organisation.

Comment

Overall, the new guidance is an informative and practical resource that clearly sets out the Regulator's expectations of how trustees should get to grips with understanding their scheme's employer covenant. This is welcome, given that the Regulator has been placing increasing weight on the importance of the covenant as an integral part of scheme risk management. The guidance will be useful for all trustees, but will be particularly helpful for those who have not previously engaged external covenant assessors, as it gives guidance on how to carry out assessments themselves, as well as points to bear in mind when commissioning an external assessment. Trustees should consider the extent to which their approach to covenant assessment may need to be modified as a result of the new guidance.

Olivia Caird

In other news...

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.

VAT recovery – further HMRC guidance

HMRC has published further guidance on the recovery of VAT charged on pension scheme services. Most importantly, this announces a 12 month extension of the transitional period under which schemes and employers can continue to follow HMRC's pre-2014 policy on VAT recovery. It also provides an update on HMRC's latest position on possible arrangements for employer recovery of VAT on pension scheme services, and sets out HMRC's view that where employers pay for asset management costs directly under a tripartite agreement, those costs do not "clearly" fall into a category which makes them deductible for corporation tax purposes. Further guidance is expected later this year.

Data protection – EU-US "Safe Harbor" agreement no longer valid

The EU Court of Justice has ruled that the EU-US "Safe Harbor" agreement for data transfers from the EU to the US should be declared invalid following Edward Snowden's revelations about the surveillance by the US National Security Agency of data held by Safe Harbor participants. This decision may have implications for pension schemes whose data is being transferred to the US, but only if the legal basis of those transfers is the Safe Harbor agreement rather than, for example, the use of the EU "Model Contract Clauses".

Increases on pre-1988 GMPs – position from April 2016

Pension schemes are not required to pay increases on GMPs that accrued prior to 6 April 1988. Currently, these increases are paid as part of the additional state pension. From 6 April 2016, the state pension regime is being replaced with a new single tier state pension. As there will no longer be an additional state pension, individuals who reach state pension age on or after 6 April 2016 will not receive increases on their pre-1988 GMPs, unless their scheme rules contain a provision requiring the scheme to pay such increases.

Changing indexation measures – further High Court guidance

The High Court has held that a scheme's rules which defined RPI as the *"General Index of Retail Prices or any replacement adopted by the Trustees without prejudicing Approval"* did not allow the trustees to change the indexation measure used to calculate pension increases and revaluation from RPI to CPI. In light of the general balance of powers in the scheme, the Court held that the wording used in the definition meant that the trustees could only adopt a "replacement" index if RPI ceased to be an officially published index. We understand that permission to appeal the Court's decision has been granted.

EMIR central clearing requirements – pension scheme exemption extended

The exemption for pension schemes from the central clearing requirements under the European Market Infrastructure Regulation has been extended for a further two years. It will now expire on 16 August 2017.

Incentive exercises – review of Code of Good Practice

The Code of Good Practice on Incentive Exercises is currently being reviewed. The Incentive Exercises Monitoring Board expects the revised Code to be published by the end of the year.

GMP equalisation – Pensions Ombudsman input

The Pensions Ombudsman has rejected a complaint from a member that his pension, and in particular his GMP, had not been calculated correctly in accordance with sex equality legislation. The Ombudsman decided, among other things, that the trustees were not guilty of maladministration in continuing to defer "equalising" GMPs whilst the issue of GMP equalisation generally remains unresolved.

Transfers – processing timescales

Two recent decisions from the Pensions Ombudsman demonstrate the difficulties that trustees face in knowing what the Ombudsman will consider to be a suitable timescale for processing a transfer request. In one case, the Ombudsman upheld a member's complaint that his transfer request had not been processed within a reasonable timeframe (even though the transfer was completed by the six month statutory deadline), concluding that a month would have been a reasonable timeframe for the scheme to have processed the transfer. However, in the second case, the Ombudsman rejected a member's complaint that his transfer request had not been processed by the statutory deadline as, based on the facts of the case, there were "valid reasons" for the delay.

Katherine Carter

Upcoming Pensions Group events at Mayer Brown

If you are interested in attending any of our events, please contact Katherine Carter (kcarter@mayerbrown.com) or your usual Mayer Brown contact. All events take place at our offices at 201 Bishopsgate, London EC2M 3AF.

- **Trustee Foundation Course**

  1 December 2015
  23 February 2016
  17 May 2016
  13 September 2016
  6 December 2016

  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 – Trustee discretions
  14 June 2016 – topic to be confirmed
  15 November 2016 – 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**
  27 April 2016

  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.

Dates and deadlines

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

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 2014

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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