MAYER | BROWN

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Trustee Guide

Introduction

This Trustee Guide is intended to be a user-friendly summary of the pensions law and regulatory framework within which pension scheme trustees operate. It is not meant to be a substitute for legal advice, for which we would ask you to consult the person at Mayer Brown who normally advises you. This Guide will be updated from time to time to reflect changes to legislation and regulatory practice. We hope that you find it a useful background source and refresher to put issues into context as they arise in relation to your scheme.

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This Guide reflects the law and regulatory framework as they stood as at 6 April 2019. It is not meant to be a substitute for legal advice, for which we would ask you to consult the person at Mayer Brown who normally advises you.

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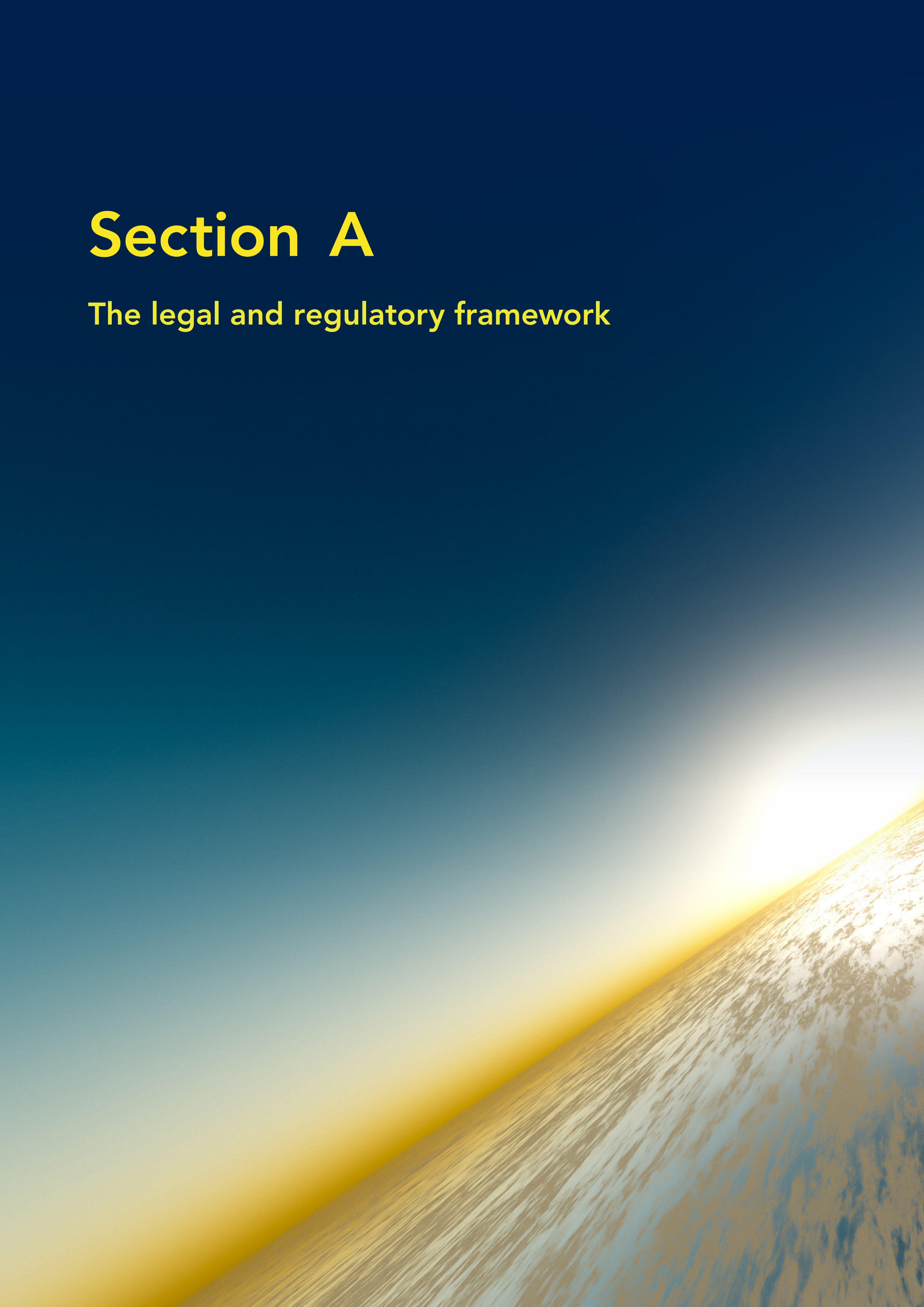


Section A

The legal and regulatory framework

1. Background

The main duties and responsibilities of trustees of an occupational pension scheme are contained in the pension scheme's own trust deed and rules. But those duties and responsibilities are supplemented, and sometimes modified, by trust law and by pensions legislation.

1.1 Types of benefit

Occupational pension schemes can provide different types of benefit. There are two basic types of benefit – defined benefits and money purchase (also known as defined contribution (DC)) benefits. Occasionally the terms "defined contribution benefits" and "money purchase benefits" have specific meanings for the purposes of the legislation governing pension schemes. However, the terms are frequently used interchangeably and, for the purposes of this Guide, we will refer to money purchase benefits as DC benefits.

(a) Defined benefits

In a defined benefit (DB) pension scheme, members are promised a guaranteed level of retirement benefit. The most common type of benefit is a final salary benefit, where members are promised a guaranteed pension of a percentage of their "final" salary for each year of pensionable service. "Final" salary is usually the member's salary on retirement or, if the member leaves the scheme before retirement, his or her salary at the time of leaving.

A career-average revalued earnings (CARE) benefit is like a final salary benefit, but is calculated by reference to the member's average salary over the period of their pensionable service, rather than by reference to their final salary.

A cash balance benefit is where members are promised a retirement pot of a guaranteed level – this is usually expressed as a pot of a fixed percentage of salary for each year of pensionable service, and is sometimes accompanied by a guaranteed investment return. The difference between this type of benefit and a DC benefit (see paragraph 1.1(b) below) is that in a DC scheme, while members receive a fixed level of contributions, they are not promised that their pension pot will be worth a guaranteed amount on retirement.

(b) DC benefits

In a DC scheme, members are promised a fixed level of contributions, usually expressed as a percentage of salary. The contributions are then invested, and the member's pot increases and/or decreases according to how those investments perform. The size of the retirement pot that the member receives is therefore dependent on the level of contributions made and how the pot is invested (plus the level of fees applied to the pot e.g. by investment managers).

1.2 Trust law

Trust law sets out the foundation of a trustee's relationship with the scheme members. We explain more about the principles of trust law later in this Section.

1.3 Legislation

The three most important pieces of pensions legislation that place duties on trustees are the Pension Schemes Act 1993, the Pensions Act 1995, and the Pensions Act 2004. The Acts themselves are fleshed out by regulations which are made under them.

These Acts and regulations supplement trust law in a number of ways, perhaps most importantly by setting down some universal rules that give trustees control over a pension scheme's investments and, to an extent, over its funding levels. The Acts also contain various overriding rules about the benefits a scheme can provide, and about the standards expected of trustees in carrying out their role. They give trustees additional rights, but also impose additional duties.

1.4 The Pensions Regulator's codes of practice

The Pensions Act 2004 established the Pensions Regulator as the body responsible for overseeing compliance with pensions legislation. The Regulator has the power to issue codes of practice, which give practical guidance on the legislation and set out standards of conduct expected of the people to whom that legislation applies. Statements in a code of practice are not law as such, but legislation does require the Courts and the Pensions Ombudsman to take them into account when deciding if a particular statutory requirement has been met.

2. Trust law

2.1 The role of a trustee

Under trust law, a trust arises wherever one person legally owns property, not for their personal benefit, but in order to provide benefits for someone else. Historically, the most common trusts were "family trusts", which were set up to provide for someone's children until they came of age. Nowadays, trust structures are also used for charities and pension schemes.

The most helpful statement about trustee duties (in the investment context) is found in a case which was actually decided in 1887 – *Learoyd v Whiteley.* A trustee is "to take such care as an ordinary prudent man would take if he were minded to make an investment…for the benefit of other people for whom he felt morally bound to provide". This illustrates the general principle that a trustee's duty may involve exercising greater care than he or she might in his or her own affairs.

2.2 Duties

Case law has developed the role of the pension scheme trustee over many years. In addition, new statutory duties and obligations, and codes of practice issued by the Regulator, have clarified and extended the role of a pension scheme trustee. The role has undoubtedly become more onerous. The classic statements of the duties of pension scheme trustees (as extended by legislation) are summarised below.

(a) To be familiar with and comply with the scheme provisions

Pension scheme trustees have always had a duty to familiarise themselves with the trust deed and rules of the scheme, so they understand the scope of the powers and duties conferred on them. This duty has now been extended by legislation to require knowledge of the scheme's financial and actuarial position and any other matters relating to its operation.

Trustees must administer the scheme in accordance with the scheme's trust deed and rules. For example, this duty means that trustees must ensure that the right benefits are paid to the right people at the right time, and that the right contributions are collected. To do this, knowledge of what benefits the scheme provides is important. Where the trustees are unclear about what is required under the trust deed and rules, they should seek guidance from their legal adviser.

A scheme's trust deed and rules generally also give trustees a wide range of discretionary powers in order to administer the scheme. For example, they usually give trustees a role in agreeing benefit changes. But individual pension schemes differ, so another important issue for trustees to understand is the "balance of powers" in their own scheme i.e. how the powers in relation to their scheme are divided between the employer and the trustees (and, sometimes, the scheme's members). This is not necessarily just a matter of looking at the literal wording of a particular rule in isolation, as case law is full of reminders that the powers under a pension scheme must be used for the purposes for which they were conferred. Understanding the purpose of one rule may mean looking at it in the context of other rules.

Trustees must also ensure that that they follow the right procedures when exercising discretions. For example, the scheme's trust deed and rules may require them to obtain actuarial advice, or the employer's consent, in particular contexts.

Trustees are frequently called upon to enter into negotiations with employers about, for example, possible changes to the scheme, contributions, transfers of assets and liabilities, or scheme reorganisations. Before making any of these decisions, the trustees must be fully aware of the extent of their powers under the scheme. This was illustrated in a 1996 case, *Hillsdown Holdings plc v the Pensions Ombudsman*, which concerned a scheme merger. The trustees agreed to the merger under a misapprehension about their powers and the purposes for which they were conferred. The merger was in effect undone because the Court decided that the trustees would not have agreed to the merger if they had understood the extent of their powers properly.

How this is supplemented by legislation

The Pensions Act 2004 supplements the general trust law duty of trustees to be familiar with their scheme with a statutory duty of "trustee knowledge and understanding" (TKU). This duty requires trustees of occupational pension schemes to be "conversant with":

- The scheme's trust deed and rules.
- The scheme's statement of investment principles (see Section E paragraph 2.4).
- (In a DB scheme) the scheme's most recent statement of funding principles (see Section E paragraph 3.2).
- Any other document recording policy adopted by the trustees relating to the scheme's administration generally.

A trustee must also have knowledge and understanding of:

- The law relating to pensions and trusts.
- The principles relating to occupational pension scheme funding and the investment of scheme assets.
- Any other matters which may be required from time to time.

The degree of knowledge and understanding required is the level appropriate in order to enable the trustee to exercise his or her functions as trustee properly. Broadly, the requirements are the same irrespective of whether the trustee is an individual trustee or a director of a trustee company. (Strictly, directors of corporate trustees are only required to be conversant with the scheme documents "so far as it is relevant to the function" which the director is exercising.)

A code of practice issued by the Regulator, and the Regulator's so-called "scope documents", set out practical guidance for trustees on how they can comply with their TKU duties. The Regulator does not expect trustees to become experts, but to be able to "understand the advice they are given by experts so that they can enter into a discussion on that advice and so that they can genuinely reach their own decisions". The Regulator believes that trustees should have sufficient knowledge and understanding so as to be in a position, if necessary, to challenge the advice received from their professional advisers.

Trustees are expected to keep up to date and fill any gaps in their knowledge.

(b) To act in the interests of the beneficiaries

In carrying out their duties, trustees must set aside their own interests and act instead in the interests of the scheme beneficiaries overall. It is important to note that trustees owe this duty to all scheme beneficiaries, not just members (and certainly not just active members). Pensioners, deferred members and survivors (e.g. spouses) who are entitled to benefits from the scheme when a member dies are clearly beneficiaries. The employers are also beneficiaries in some contexts: they may stand to receive a refund of surplus in certain situations, particularly on a winding-up if there are assets left over after providing for all the promised benefits – a situation that used to be more common than it is now. The interests of the beneficiaries are usually their financial interests. Trustees can also take the employer's interests into account provided that they are satisfied that the scheme's primary purpose (i.e. to provide the promised benefits to the members) will still be met.

Trustees must consider all of their options, and think about the indirect effects of their actions as well as the direct effects. The trustees' duty to act in the interests of the beneficiaries overall does not mean that the trustees can never make a decision that is detrimental to any beneficiaries. Some changes may be proposed that would benefit some beneficiaries and disadvantage others.

(c) *Trustees are entitled to prefer some beneficiaries over others*

Although trustees should consider the interests of all of their scheme's beneficiaries, they do not have a duty to treat all groups of beneficiaries equally in exercising their discretion. They can if they want to. But the exercise of a discretion is by its very nature done in a subjective fashion. A decision cannot be set aside because somebody else thinks that it was not fair. For example, granting a discretionary increase to pensions in payment may appear unfair to members who have not retired if there is no corresponding improvement to their rights. But as long as the trustees have approached the decision properly, there will be no basis for invalidating it.

(d) *To act prudently and carry out duties conscientiously and with the utmost good faith*

Trustees should be diligent and prudent. The trustee's job is to make the decisions necessary to ensure that the right benefits are paid to the right beneficiary at the right time.

How this is supplemented by legislation

The Pensions Act 2004 requires trustees to put in place an effective system of governance, including internal controls in order to assess and manage risks to which the pension scheme is exposed – see Section C paragraph 1.2 for more details. In addition, trustees must be mindful of their whistle-blowing and (in the DB context) notifiable events obligations under the Pensions Act 2004 – where certain events and breaches of law of material significance to the Regulator must be reported. See Section C paragraphs 1.4 and 1.5 for more information on these reporting requirements.

(e) *To safeguard, and to invest, the scheme assets*

Investment is one of the central responsibilities of trustees, because ultimately pension scheme members are relying on the trust assets for their benefits. Although in practice day-to-day investment decisions are almost always delegated to an investment manager, the law nevertheless requires that trustees retain overall responsibility for investment strategy and for supervising the performance of investments.

How this is supplemented by legislation

Trustees must ensure that they prepare a statement of investment principles and that this is revised from time to time. This statement will set out the types of investments to be held and the risk/return balance.

Legislation also requires trustees to take advice before making strategic investment decisions. There are statutory restrictions on certain types of investment. We explain this more fully in Section E paragraph 2.1.

(f) *To take advice on matters requiring specialist knowledge*

Trustees may need specialist advice in a number of different contexts – including actuarial, investment, legal and, increasingly, employer covenant advice.

How this is supplemented by legislation

Trustees have a statutory duty to appoint a scheme auditor, and in DB schemes, a scheme actuary. Where the scheme's assets include investments covered by financial services legislation, a fund manager must also be appointed.

The Pensions Act 1995 requires certain appointment formalities to be completed before trustees can rely on advice from a third party. See Section C paragraph 1.6 for more information on advisers.

(g) Not to put themselves in a position where interest and duty conflict

Trustees must put their own personal interests (and other duties) aside in order to fulfil their responsibilities to the scheme beneficiaries. The basic principles about conflicts of interest and conflicts of duty were summarised in a 1986 case, *Re Thompson's Settlement*. The Court explained that "…a man must not put himself in a position where duty and [personal] interest conflict or where his duty to one conflicts with his duty to another…". We discuss conflicts in more detail in Section B paragraph 3.3.

3. Discretions

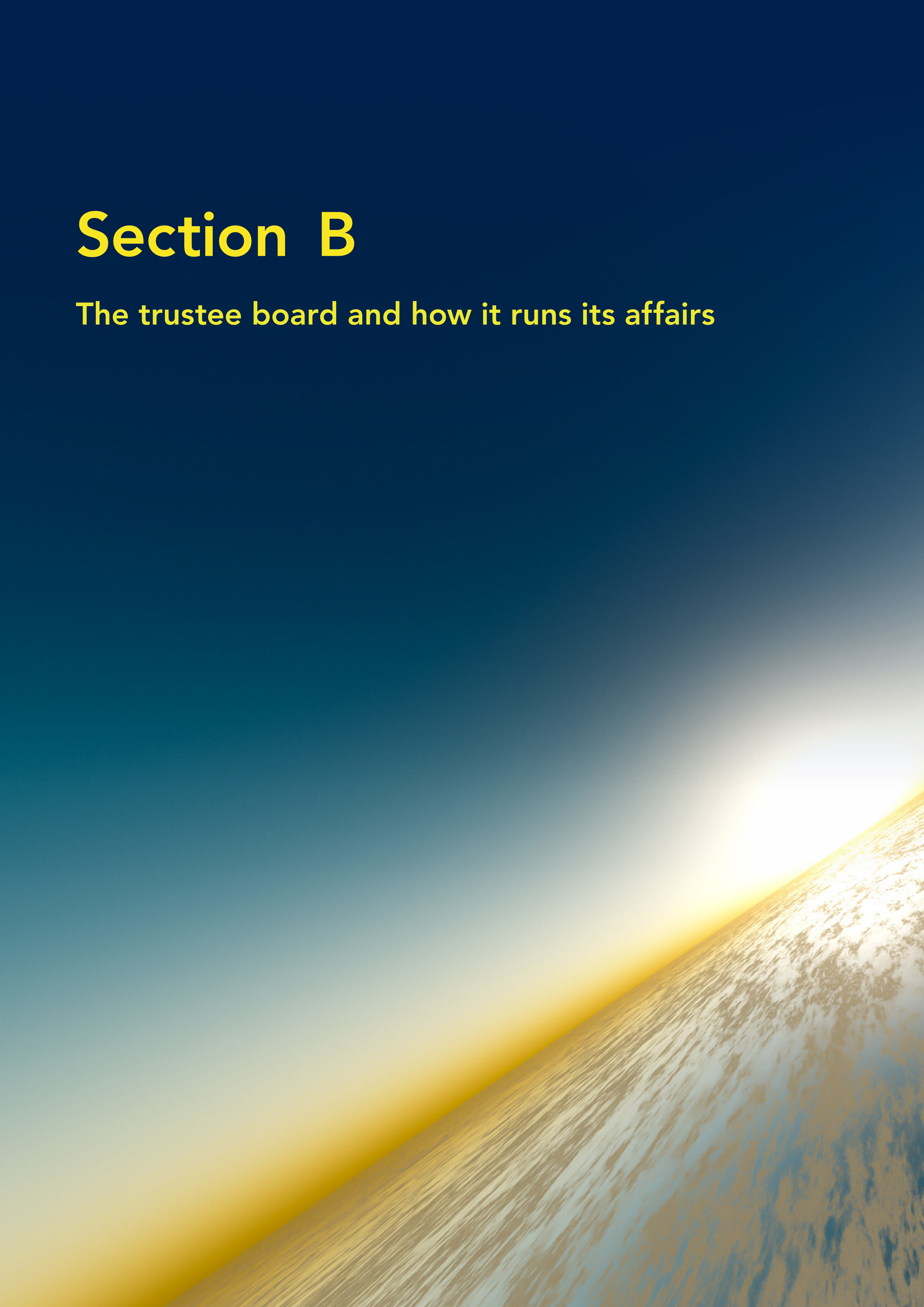
We mentioned trustee discretions earlier. Trustees have a discretion where the scheme's trust deed and rules give them the power to decide whether or not to do something. Schemes differ in the areas where trustees are given a discretion. While there are no standards, trustees typically have discretions over how lump sum death benefits are distributed, whether to pay a dependant's pension or an ill-health pension, and whether to agree to a rule amendment proposed by the employer.

Trustees exercising a discretion may do so only within the terms of the power they are given. For example, a typical scheme rule about making lump sum payments after a member dies includes a list of relatives, dependants and so on, and gives the trustees a discretion about which of the people on the list they will actually make the payment to. But the trustees cannot decide to pay the lump sum to someone who is not on the list, however strongly they feel that that person ought to get the payment – the trustees would be acting outside the terms of the discretion, and beyond their powers, if they did so. It is therefore important to look at precisely what the rules say.

As well as having to act within their powers, trustees who are exercising a discretion:

- Must act in good faith.
- Must not reach a perverse decision (i.e. one which no reasonable body of trustees could have reached).
- Must take all relevant factors into account (while disregarding irrelevant factors).

If they fail to take a relevant factor into account, or breach those principles in other ways, a Court or the Pensions Ombudsman can declare the trustees' decision invalid and require them to take it again. Obviously that can be problematic if the trustees' original decision was to pay money to one person and they have already made the payment. However, the Ombudsman and the Courts cannot normally replace the trustees' decision with their own, just because they do not agree with it and would have done something different themselves.



Section B

The trustee board and how it runs its affairs

A scheme's trustee board may be made up of a number of individual trustees, or the scheme may have a single corporate trustee with a board made up of individual directors. A corporate trustee is probably the more common structure nowadays.

1. Corporate trustee or individual trustees

Where a scheme has individual trustees, decisions about the scheme are taken by those individuals. Where the scheme has a corporate trustee, decisions about the scheme are taken by the board of directors of the trustee company.

Individual trustees are appointed or removed in whatever manner the scheme's trust deed provides for – this usually requires the scheme's employer to sign a formal deed of appointment or deed of removal. Directors of a corporate trustee are in practice appointed or removed in accordance with the so-called "articles of association" of the trustee company, and by filing the relevant forms at Companies House.

Generally speaking, individual trustees are personally liable for any actions or omissions on their part which constitute a breach of trust – though this is subject to any exoneration clauses or indemnities in the scheme's trust deed and rules (see Section F paragraph 5 for more details).

Where the scheme has a corporate trustee, it is technically the trustee company, not its board of directors, who would be liable for any breach of trust, and the directors of the trustee company are not personally liable (except in very extreme circumstances such as fraud on the part of the director). Many pension schemes therefore prefer to use a corporate trustee.

2. Member-nominated trustees and member-nominated directors

Since 1997, legislation has given scheme members the right to choose to be represented on the trustee body.

2.1 The key requirement

The precise requirements have changed since 1997, but the current general rule is that at least one third of the trustee board must be made up of member-nominated trustees (MNTs) (or member-nominated directors (MNDs) if a company is the scheme's sole trustee). Trustee boards can have more MNTs/MNDs than the one third minimum if the employer agrees, or if the scheme's own trust deed and rules require a greater number.

2.2 Complying with the key requirement

The Pensions Regulator's code of practice on MNTs/MNDs does not specify exactly how trustees must comply with the legislation. However, the Regulator does expect trustees to consider three principles – proportionality, fairness and transparency – in deciding how to comply. The code of practice also encourages trustees to record the steps they have taken to comply with the law.

The code of practice also suggests that in setting up their MNT/MND arrangements, trustees should consider consulting with the employer on various matters. These include eligibility criteria, what the term of office for an MNT/MND should be, and what should happen if an MNT/MND resigns or ceases to be a scheme member.

If the employer approves, the arrangements can provide for someone who is not a member of the scheme to qualify for selection as an MNT/MND. Trustees who want non-members to be eligible to fill an MNT/MND role should therefore check that the employer does in fact agree to this.

2.3 Nomination and selection processes

The MNTs/MNDs must be nominated by a process involving at least all the active members and pensioners (beneficiaries receiving a survivor's pension are not "pensioners" for these purposes), and/or organisations which adequately represent active members or pensioners. For schemes with no active members or pensioners, the nomination process must involve "at least such deferred members as the trustees determine are eligible to participate".

The MNTs/MNDs must be selected by "some or all of" the members. The selection process may also involve representative organisations, and should provide for a combination of methods if more appropriate. If there are fewer nominations than vacancies, the trustees may decide that the nominees are deemed to be selected, or they may still run a selection process anyway. The arrangements should ensure that people nominated and selected consent to becoming MNTs/MNDs. They must then be appointed.

The Regulator's code of practice sets out details of what the Regulator believes should be included in communications to members and/or organisations, and how trustees should communicate.

2.4 Reviews and re-runs

The Regulator expects trustees to review their MNT/MND arrangements every three to five years (or earlier if the scheme's circumstances or membership change materially – for example, if it closes to future accrual or if a large number of new members join as a result of a merger with another pension scheme). When new arrangements are to be implemented, legislation says this should happen within a "reasonable period". The Regulator has stated that a reasonable period for implementing arrangements is up to six months.

It can happen that there are too few nominations to fill the MNT/MND positions available. In this case, the Regulator considers that a reasonable interval for re-running the nomination process is up to three years. (Trustees may decide to include deferred members in a re-run if they were not previously involved.) If the scheme's membership changes significantly, then an earlier re-run may be appropriate.

2.5 Treatment of MNTs/MNDs

An MNT or MND cannot be removed from office without the agreement of all the other trustees/directors. (There is an exception where the scheme's trust deed and rules say that scheme members themselves have the right to remove MNTs/MNDs. In that situation, the trust deed and rules continue to apply instead.)

MNTs/MNDs must not be excluded (because of their status) from any functions exercised by the other trustees. So, for example, a rule saying that the chair of the trustee board can never be an MNT/MND would be ineffective.

3. Proceedings of the trustee board

Procedural aspects of trustee meetings are usually governed by the scheme's trust deed and rules if the scheme has individual trustees, or by the trustee company's articles of association if the scheme has a sole corporate trustee. Legislation may also be relevant, but in practice much of the relevant legislation only applies where the scheme has individual trustees.

3.1 Calling meetings

Where a scheme has individual trustees, and a decision is to be taken by majority agreement at a trustee meeting or on any other occasion, then – unless the decision is to be made as a matter of urgency – legislation says that notice must be given at least 10 business days in advance to all the trustees to whom it is reasonably practicable to give it. The notice must specify the date, time and place of meeting or other occasion unless all of the trustees agree otherwise.

There are no comparable statutory rules that apply to meetings of the directors of a sole trustee company. The trustee company's articles of association will set out how meetings of the trustee directors are to be convened, constituted and conducted. The articles may set out specific provisions for notice of meetings, and may also deal with paper meetings and meetings by telephone.

3.2 Conduct of meetings

Schemes' trust deeds normally give trustees a lot of flexibility to decide for themselves how they regulate their business. A typical scheme trust deed and rules will provide that the trustees themselves can decide the manner in which their meetings shall be called and conducted.

Unless a scheme's trust deed and rules (or a trustee company's articles of association) expressly say otherwise, decisions of trustees may be taken by majority agreement. Where decisions are to be taken by majority agreement, the trust deed and rules or articles of association may specify that a minimum number of trustees (a "quorum") must be present in order for the decision to be valid.

There are certain exceptions to majority voting. For example, as we mentioned earlier, removal of an MNT or MND requires the agreement of all the other trustees/directors. Also, unless the trust deed (or company's articles of association) say otherwise, decisions that are taken by written agreement of the trustee body, rather than at a meeting, must be agreed by all the trustees (or directors).

3.3 Conflicts of interest and conflicts of duty

(a) Introduction

The Regulator has made it clear that it views management of conflicts by trustees as integral to good governance. Some of the principal strands in this area from general law and from the Regulator's publications to date are set out below.

Conflicts of interest and duty are a fact of life in pension schemes. Nearly all schemes have a mix of MNTs and senior company managers as trustees. Naturally these individuals may have an interest in the sponsoring employer's business as well as in the scheme. A trustee's primary duty is to the beneficiaries of the trust, and any pension scheme trustee who fails to carry out his or her duties as a trustee to the scheme's beneficiaries could be judged as having committed a breach of trust.

But at the same time, trustees who are employees also owe their employers various duties. For example, an employee is under an implied contractual obligation under employment law not to use or disclose to third parties information of a confidential nature that he or she may have learnt in the course of their employment. This duty to preserve confidential information is often enhanced by an express clause in the employee's employment contract regarding the use of confidential information. But the same information could also be relevant to a decision which the trustees are required to take – creating a conflict of interest (or more accurately a conflict of duty) for the trustee concerned, who will also have a duty to use that information for the advantage of the scheme's beneficiaries. The issues may be more difficult still where the person is a director of a sponsoring employer, because there is then a competing duty of confidentiality owed to that company, and the director's information may be even more confidential than that of a less senior employee.

Where a trustee is in doubt as to their position, he or she should ask the trustee board to seek legal advice.

(b) The Regulator's guidance on conflicts

The Regulator's guidance concentrates on the governance aspects of managing conflicts. The Regulator acknowledges that aspects of the law on conflicts of interest are unclear, and that its guidance is not a substitute for taking legal advice. The Regulator takes the view that conflicts "can inhibit open discussions or result in decisions, actions or inactions that are not in the best interests of beneficiaries. This, in turn, may result in trustees acting improperly, lead to a perception that trustees have acted improperly, and may invalidate a decision or transaction".

Throughout its guidance, the Regulator consistently recognises the benefit to the scheme of having senior employees, including directors, of the sponsoring employer serve on the trustee board. The Regulator appreciates that conflicts are inherently likely to arise before and after appointing such individuals as trustees, and that it is vital that these conflicts are appropriately identified, monitored and managed. Equally, however, the Regulator takes conflicts of interest seriously and has intervened where trustees have failed to resolve conflicts of interest.

The Regulator emphasises that there should be a culture of openness (it says "disclosure of conflicts should be embraced, not ignored") and expects "all conflicts of interest to be resolved sensibly". The Regulator has identified five high-level principles which it urges trustees to consider in developing their own approach to conflicts. The principles are:

- Understanding the importance of conflicts of interest.
- Identifying conflicts of interest.
- Evaluation, management or avoidance of conflicts.
- Managing adviser conflicts.
- Having a conflicts of interest policy.

The Regulator takes the view that the chair of the trustee board should play a key role in the management of conflicts, and that it is the chair's job to make sure that trustees are aware of their responsibilities and that conflicts are declared and managed or avoided. The Regulator's guidance suggests that an independent chair is ideally positioned to supervise conflicts management and avoidance procedures.

The Regulator has also made it clear that no individual is precluded from being a trustee simply because of the position they otherwise hold – whether as a trade union official or a finance director. But the Regulator's expectation is that trustees and employers will plan in advance their approach for when a conflict of interest arises, and believes the key to any successful conflicts management programme is production of a policy outlining the processes for identifying, monitoring and managing conflicts. The first step is to identify the conflict and for the trustee in question to disclose the conflict in line with the procedure under the scheme's conflicts policy. The conflict can then be evaluated.

In evaluating the conflict, the issues that will need to be assessed are:

- The significance of the decision to be made.
- The impact that the conflicting interest might have on the trustees' discussions and decision-making process.
- The affected trustee's ability to act in the interests of all scheme beneficiaries.
- Whether a perception of the conflict of interest by the beneficiary or beneficiaries or by the sponsoring employer(s) would lead to a lack of support for the decision made or a lack of confidence in the trustee board.

Where the nature of the conflict cannot be disclosed, then it may be appropriate to exclude the conflicted trustee.

After the conflict has been assessed, the chair or the trustee board will be able to determine the best response, after taking legal advice if appropriate. Guidance given to a conflicted trustee will vary according to the nature of the conflict.

Some options are set out below:

- Allow the trustee to participate without imposing any conditions on the trustee's participation. It is crucial to determine whether the subject matter under consideration is material or non-material.
- Require the trustee to abstain from discussing and voting on a particular issue. This option is practical if the issue is an infrequent, rather than a recurring, issue.
- Require the trustee to delegate his or her functions on a temporary basis. Again, this option is generally only practical where the issue giving rise to the conflict is an infrequent, rather than a recurring, issue.
- A trustee could resign, either before he or she becomes conflicted, or once a conflict arises. This may not generally be a practical or sensible solution, as the trustee board may lose the experience or expertise of a particular trustee and it may be difficult to fill the "gap" – especially if urgent action is required.
- In the event that all or a majority of the trustees have acute conflicts, consideration should be given to whether the appointment of an independent trustee would be appropriate. This would need to be agreed with the sponsoring employer. (Ultimately, an application to the Regulator may be required.)
- Apply to Court for advance approval of a decision or action. This is likely to be time-consuming and costly and so is an appropriate solution only for an issue which is of major importance, but which is not urgent.

If a trustee refuses to withdraw when so requested, the chair should adjourn the trustee board meeting to consider, along with the legal advisers, the best course of action.

Finally, for conflicts of interest to be managed appropriately and effectively, they need to be recorded in a conflicts register.

(c) Managing conflicts of interest

Conflicts of interest may arise in connection with the normal administration of the scheme, but they can generally be managed, as long as they are disclosed to the trustee board. Trustees can, for example, properly agree discretionary increases to benefits even when they themselves may benefit, as long as the proper process has been followed (and this position has been given statutory recognition). It is usually foreseeable that certain types of conflict may arise in a particular situation. The trustee concerned should discuss with his or her employer, and if necessary with the trustee board, how he or she would expect to deal with such a case (managing expectations).

(d) Managing conflicts of duty

The principal challenge appears to be in relation to conflicts of duty. There are two facets to this – negotiations between the trustee board and the sponsoring employer, and the management of confidential information.

As for negotiations, it is clear that an individual cannot sensibly place himself or herself in a position where he or she is expected to negotiate (with one "hat" on) with, in effect, himself or herself (wearing another "hat"). And the Regulator has made it very clear that it expects a trustee who could be involved in both sides of the negotiation to absent himself or herself from trustee meetings when the issue is discussed and to play no part in decision-making.

As for the management of confidential information, it should be possible for the trustee board and the sponsoring employer to agree a basic approach for the handling of almost all confidential information – which protects individuals who may otherwise be caught in the middle.

While clearly the same person cannot be on both sides of a negotiation, the Regulator seems to expect that the "appropriate information" relevant to the matter under negotiation (for example, the financial position of the sponsoring employer) should be shared openly. In practice, therefore, it is probable that a sponsoring employer will be expected to disclose to the trustee board almost all information that is relevant to the trustee board's decisions.

So the sponsoring employer might simply agree that any employer information it gives an individual who is also a trustee director can be disclosed to the rest of the trustee board (subject to the trustee board agreeing to keep it confidential). Appointing a person to be a trustee may in fact imply consent on the part of the employer to such disclosure. The Regulator has suggested that, if necessary, the trustee directors could sign confidentiality agreements.

It may be that occasionally there will be a timing issue – that the sponsoring employer has no objection to disclosure in principle, but wishes to keep the information confidential until it is ready to approach the trustee board itself. The Regulator has said that disclosure of information must be "timely" – so provided the delay does not disadvantage the trustee board's position, there is probably no issue here.

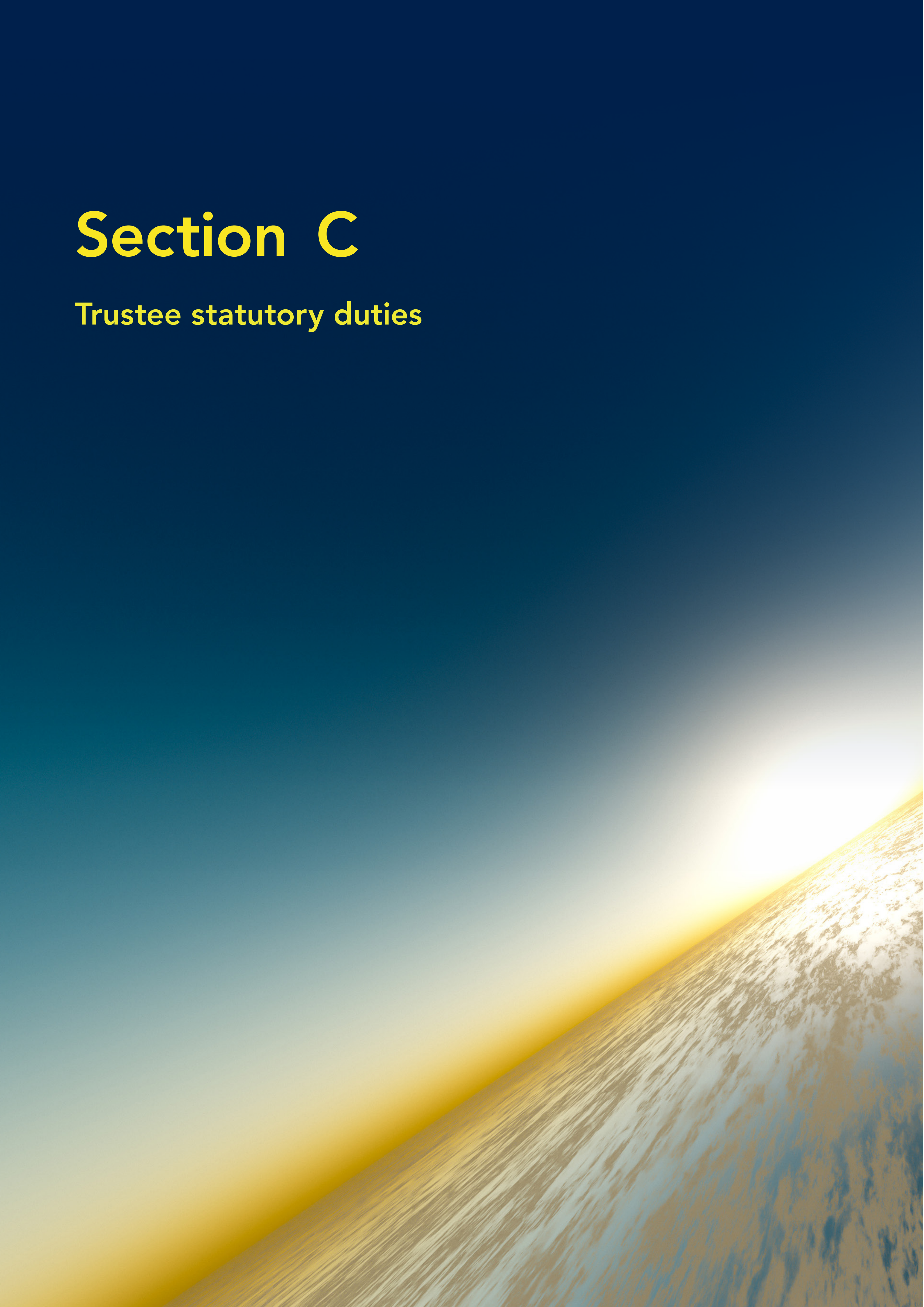
Trustees must put their own personal interests (and other duties) aside in order to fulfil their responsibilities to their beneficiaries.

4. Confidentiality

Trustees are given a confidential role and the Courts recognise that carrying out trust business – in particular, making the discretionary decisions that trustees are required to make under the trust deed and rules – would become almost impossible if trustees were automatically bound to disclose everything to beneficiaries.

Trustees should proceed on the basis that their discussions and decisions, and documents and information presented to trustee meetings, are confidential and should not be disclosed to a third party without the agreement of the trustee board. That is an absolute rule where personal data about individuals is concerned – see Section C paragraph 2.4 for a discussion of trustees' data protection duties.

However, trustees should note that anyone who is potentially eligible to receive benefits from a trust may be able to ask a Court to order disclosure to them of anything that counts as a "trust document". The Pensions Ombudsman can also order disclosure. Broadly speaking, a trust document is a document which was created for the purpose of the scheme, and which is held by the trustees. Agendas, minutes and letters/reports containing advice may all be trust documents. So while members may not be entitled to see these documents as of right, it is sensible to bear in mind that they could end up being disclosed if a Court or the Ombudsman decides it is appropriate – see Section C, paragraph 2.1 for further details on the minuting of trustee decisions.



Section C

Trustee statutory duties

1. Trustee obligations

1.1 Trustee knowledge and understanding

The Pensions Act 2004 requires trustees to have appropriate knowledge and understanding of pensions and trust law and the principles of scheme funding and investment. The level of knowledge required is that which enables them to perform their functions as a trustee of the scheme. They must also be conversant with their scheme's documentation and any other documents relating to the administration of the scheme. See Section A paragraph 2.2(a) for more details.

1.2 Governance and internal controls

(a) Background

Trustees are required by legislation to establish and operate an effective system of governance that includes internal controls. This duty was introduced in January 2019 – prior to that, the duty was limited to a requirement for trustees to establish and operate internal controls. The detail of what is required by the new duty to establish and operate an effective system of governance is to be set out in a Pensions Regulator code of practice. (At the date of writing, this code has not been published.)

The term "internal controls" means:

- Arrangements and procedures to be followed in the administration and management of the scheme.
- Systems and arrangements for monitoring that administration and management.
- Arrangements and procedures to be followed for the safe custody and security of the scheme's assets.

Essentially, internal controls are a risk management process.

The Regulator has issued a code of practice and related guidance (available on its website) which set out the Regulator's expectations of how occupational pension schemes should satisfy the requirement to have internal controls in place.

The Regulator recognises that not all risks will have the same potential impact, and that some risks are more likely to materialise than others. Trustees should consider both of these aspects and assess which risks the scheme can absorb without the need to take further action, and which risks require adequate internal controls to reduce their incidence and impact.

The idea behind setting up internal controls is that trustees should focus on the key risks that need to be addressed. Although there is no explicit statutory requirement to report a lack of adequate internal controls, the Regulator would expect a whistle-blowing report to be made (see paragraph 1.5 below) if not having adequate internal controls is likely to be of material concern to it. The guidance accompanying its code of practice on internal controls gives an example of how a risk management process might work in practice.

The code of practice on internal controls says that trustees may wish to include a positive statement in their annual report confirming that they have considered key risks and the effectiveness of the controls they have put in place to mitigate those risks (as yet, there is no statutory requirement to make this statement).

(b) How might internal controls work?

The Regulator's guidance recommends that trustees undertake a risk review and set up a risk register which they then review from time to time. An example of a risk register is available on the Regulator's website.

The process to be followed could be along the lines set out below.

- *Set objectives*

  Decide which activities are fundamental to running the scheme (for example, safeguarding scheme assets, being suitably funded, paying the right benefits, and complying with the law and the scheme's trust deed and rules).

- *Identify the risks*

  Identify the risks applicable to each activity, including external risks resulting from delegated services, and then set up a risk register and list all the risks identified.

  There are two main categories of risk: operational and financial. Operational risks involve day-to-day activities. Financial risks could apply to the scheme itself or the sponsoring employer (which is much the same thing), so trustees should review the sponsoring employer's covenant regularly. Following the regulatory requirements in respect of funding, notifiable events etc. should also help manage a scheme's financial risk.

- *Define success criteria*

  Trustees need to set the levels of risk that they consider to be acceptable. This could involve looking at the possible impact of the risk materialising on the security of members' benefits, disruption to the smooth running of the scheme, and the direct financial cost to the scheme. Trustees should record on the register the degree of risk that they are willing to accept and who "owns" each risk.

- *Assess risks*

  Trustees will need to assess the severity of a risk before deciding whether it requires mitigating action. For example, they could assess the likelihood of the risk occurring along with the severity of the impact on the scheme's objectives by using a traffic light system of green, amber and red. Green would be an acceptable level of risk. Amber would not represent an immediate threat to members' interests, but would be a risk that should be monitored to prevent it from becoming red. A red risk would be one providing critical exposure and requiring immediate action. All of this would need to be recorded on the risk register.

- *Produce and implement an action plan*

  Trustees should produce an action plan setting out the responsibilities and timescales for implementing the controls. They need to decide whether the control already exists, whether it is adequate, and whether a new control is needed. The action decided upon might be designed either to reduce the likelihood of the event occurring or to limit its impact if it does occur.

  In essence, controls can be preventative (for example, password protection), detective (for example, reconciliations), deterrent (for example, a disciplinary procedure), or corrective (for example, a back-up procedure). The cost of mitigating a risk should be proportionate to the potential impact of the risk.

The action plan should specify the order of priority for carrying out the work, who owns each risk, who is responsible for carrying out the actions, timescales for completion, resources, and costs. The risk owners and other people responsible for the actions in the plan must make sure that they meet the timescales for implementation and put the correct controls in place.

- *Monitor and review*

  Internal controls and scheme risks should be reviewed on a regular basis. Triggers for such reviews may include changes to legislation, changes to scheme membership, reorganisation of key staff in the scheme's administration, delegation of services, changes to the scheme structure, and changing views about what is and what is not acceptable. As well as reviewing their own internal controls, trustees should check on a regular basis those of third parties.

(c) Integrated risk management

In its code of practice on DB scheme funding, the Regulator advocates the use of what it calls "integrated risk management". This is an approach to risk management which recognises that, in the DB scheme context, funding, investment and employer covenant risk are interlinked and cannot be considered in isolation. The Regulator therefore recommends that, when considering a risk in one of these areas, schemes should consider the potential impact of that risk on the other two areas. Schemes are not required to put an integrated risk management framework in place that is separate to their internal controls framework. However, schemes may wish to consider adjusting their internal controls framework so that it deals with funding, investment and employer covenant risk in an integrated manner if it does not do so already. The Regulator has published guidance for trustees on integrated risk management.

1.3 Regular reporting

The Regulator uses its register of occupational and personal pension schemes as one of its sources of information. The Regulator issues scheme returns annually to those schemes which are on the register (unless the scheme has 12 or fewer members), so that it can keep the information on the register up to date. Not complying with the Regulator's notice to fill out the scheme return may result in a fine being imposed by the Regulator.

Employers must pass to the trustees all employee pension contributions (including additional voluntary contributions) within 19 days of the end of the month in which the contributions were deducted from pay (or 22 days if contributions are paid over electronically). Trustees are expected to monitor compliance with this, and must report any late payments to the Regulator (if the trustees reasonably believe that the late payment is of material significance to the Regulator) as well as to the member. The Regulator has published a code of practice on this reporting obligation in relation to DC schemes.

1.4 Notifiable events

Legislation requires employers and trustees of DB pension schemes to notify the Regulator if certain so-called "notifiable events" happen. The list of notifiable events for trustees is different from the list that applies to employers. The current lists for trustees and employers are set out at the end of this Guide.

This system is aimed at giving the Regulator warning of events that might put the scheme's funding at financial risk, therefore enabling the Regulator to intervene. The Regulator has published a code of practice and related guidance on notifiable events.

The report has to be made in writing as soon as reasonably practicable after the person becomes aware of the event. This means the notifiable event has to be reported as a matter of urgency which may mean by the next working day. Failure to report the notifiable event could give rise to civil penalties and, although it will not lead to a transaction being unwound, the Regulator will consider a failure to notify when deciding whether to issue a contribution notice. Notification can be made via the Regulator's Exchange website.

The government announced in February 2019 that changes would be made to the list of employer-related notifiable events, but it is not currently clear when these changes will be made. There will be two new notifiable events. These are:

- The sale of a material proportion of the business or assets of a sponsoring employer which has funding responsibility for at least 20% of the scheme's liabilities.
- The granting of security on a debt to give that debt priority over debt to the scheme.

1.5 Whistle-blowing

The Pensions Act 2004 imposes duties on trustees and others to report material breaches of the law to the Regulator. As a result, all the following persons have a legal duty to report breaches to the Regulator:

- Trustees (if the trustee is a corporate body, and the individuals concerned are trustee directors, the requirement to report falls on the trustee company).
- Any other person involved in the administration of a pension scheme.
- Sponsoring employers.
- Professional advisers to the scheme – actuaries, auditors, legal advisers, fund managers and custodians – and any other person involved in advising the trustees in relation to the scheme.

Unlike the notifiable events duty, the whistle-blowing duty applies in relation to <u>all</u> occupational pension schemes – not just DB schemes. The Regulator can fine anyone who, without reasonable excuse, fails to comply with the duty to report.

(a) Which events have to be reported?

Not all breaches need be reported. The obligation to report arises when a person has reasonable cause to believe that:

- a duty relevant to the administration of a pension scheme (imposed by legislation or a rule of law) has not been complied with; and
- that breach is likely to be of material significance to the Regulator in the exercise of its functions.

This means that what should be reported is partly a matter of judgement. The Regulator has published a code of practice and related guidance to help people identify when reports should and should not be made.

(b) "Reasonable cause to believe"

Having "reasonable cause" to believe that a breach has occurred means more than merely having a suspicion which cannot be proved. The facts should usually be checked with someone who can confirm what has happened. Potential reporters who are unsure what the precise legal duty is should clarify their understanding of the law to form a view.

(c) *"Likely to be of material significance" to the Regulator*

Whether a breach is "likely to be of material significance" to the Regulator depends on:

- The cause of the breach – for example, was someone being dishonest, or might the breach be symptomatic of a wider problem?
- The effect of the breach – for example, has anyone lost out, or has benefit security been jeopardised?
- The reaction to the breach – for example, what is being done to investigate or resolve the problem?
- The wider implications of the breach – for example, did it involve another scheme directly, or, if an outside administrator caused the breach, might other schemes have similar problems?

(d) *What about a reporter's other duties?*

The duty to report breaches of the law overrides any other duty a reporter may have, such as a duty of confidentiality or a contractual promise not to report.

Importantly, however, the duty to report breaches of the law does not override "legal privilege". If communications between legal advisers and trustees (or their representatives) are made in connection with giving legal advice or litigation, they are "privileged" and do not give rise to a duty to report. The same goes for items referred to in those communications.

However, where a third party (for example, a scheme actuary) also sees the communications, they may not be privileged in that party's hands, even if they are about legal advice. As a result, that party may have a duty to make a report to the Regulator if they see those communications, even though the legal adviser does not.

(e) *Telling the Regulator about the breach*

Where a breach is one that that should be reported, it should be reported as soon as reasonably practicable. Timing will depend on the circumstances, but as a guide, the more serious the potential breach and its consequences, the more urgent the need to report.

Reports should be made in writing and can be made via the Regulator's Exchange website. Once one person has reported a breach, the Regulator does not require further reports of it from other people unless they have new or different information about the breach. The Regulator encourages reporters to tell others who might have a duty to report the same breach.

(f) *Practical arrangements*

Trustees, and anyone else with a duty to whistle-blow, should put arrangements in place to meet their duty to report breaches of the law. The Regulator suggests that a satisfactory procedure will include some of the following features:

- Arrangements for clarifying the law and the facts where appropriate.
- Arrangements for deciding if a breach is of material significance – a clear process of referral to someone senior enough to decide if a report should be made.
- A procedure for dealing with difficult cases.

- A timeframe for the procedure to take place.
- A system to record breaches.
- A process for identifying breaches so serious that they must always be reported.

1.6 Advisers

(a) *Who are the advisers?*

- *Compulsory appointment – scheme actuary and auditor*

  The Pensions Act 1995 requires trustees of occupational pension schemes to appoint:

  - An individual to act as the scheme actuary (unless the scheme only provides DC benefits).
  - An individual or firm to act as auditor.

- *Fund managers*

  Where the scheme assets include investments which are covered by financial services legislation, the trustees must also appoint a fund manager. This duty does not apply to a scheme whose only investments are certain types of insurance policy.

- *Investment consultants*

  Trustees almost always appoint an investment consultant to advise on investment strategy (as distinct from a fund manager who actually makes day-to-day investments for the scheme). However, the trustees retain overall responsibility for investment strategy and for supervising the performance of fund managers.

- *Legal advisers*

  It is usual for trustees to appoint legal advisers, among other things to advise on the questions that often come up about what legislation or the scheme's trust deed and rules require in a particular context, to draft scheme documents, or to review contracts – for example investment management agreements or administration contracts – which the trustees are asked to enter into.

- *Other advisers*

  Other advisers can be appointed – for example, custodians and specialists in assessing the employer covenant.

(b) *Appointing and removing advisers*

Certain professional advisers must be appointed in line with regulations made under the Pensions Act 1995. These include the actuary, auditor, fund manager, investment consultant, legal adviser and custodian). These advisers must be appointed in writing (setting out certain key pieces of information), and the trustees must receive acknowledgement of the notice of appointment from the adviser. Other advisers, such as a covenant adviser, do not need to be appointed in accordance with these requirements, but as a matter of good practice, trustees should enter into written terms of appointment with such advisers.

If an actuary or auditor resigns or is removed, he or she must confirm, in a specified manner, whether there are any circumstances connected with the removal or resignation that, in his or her opinion, significantly affect the interests of members (including prospective members) or beneficiaries.

When an auditor or actuary stops acting for the scheme, the trustees must appoint a replacement auditor or actuary within three months, and they must provide a copy of the previous auditor/actuary's statement about the effect of his or her removal or resignation to the new auditor/actuary as well as to the remaining auditor/actuary.

2. Disclosing and protecting information

2.1 Minutes of trustee meetings

Legislation sets out a basic standard for the maintenance of minutes (and other records) by trustees. Records should be kept of any meetings of the trustees. This includes meetings of trustee sub-committees.

The records should state the time, date and place of the meeting, the names of all trustees invited to the meeting, the names of the trustees who did and did not attend, the names of any other persons (including professional advisers) who attended, and any decisions made at the meeting. If any decisions have been made by trustees between meetings, the record of the next meeting should state the time, date and place of the occasion at which those decisions were made, and the names of the trustees who took part in making those decisions. Records of trustees' meetings should be kept for at least six years from the end of the scheme year to which they relate.

In terms of recording discretionary decisions made, our view is that generally trustees should consider listing the factors they have taken into consideration, but not necessarily the relative weights that they attached to the different factors they considered.

2.2 Disclosure to members and professional advisers

There is a wide range of requirements for trustees to disclose information to members or others, and for other people to disclose information to trustees.

Starting with trustees' duties towards members, some information must be disclosed automatically, such as basic information about the scheme, which must be given to new and prospective members. (This is usually included in a scheme booklet.) Changes to that basic scheme information – for example, a change to a scheme's main benefit rules – must also be disclosed to affected members as a matter of course, if possible before the change is made, and in any event within three months after it is made.

Further information – for example, statutory illustrations of the value of DC benefits and DB summary funding statements – must be provided to members at annual intervals, or at a particular stage in a person's membership (for example, when a member leaves service or starts drawing benefits), or when a particular event occurs (for example, if the scheme goes into winding-up, or in advance of a transfer of members to another pension scheme).

Other information need only be provided where requested (for example, copies of the scheme's trust deed and rules or its actuarial valuation). Schemes offering DC and cash balance benefits have additional disclosure obligations.

A communication exercise with members must be carefully managed to ensure that it is effective. If discussions are held with scheme members without a clear understanding as to how decisions have been or are to be taken, the risk is that members may get distorted or confused messages as to why decisions have been taken which do not in fact fairly reflect the trustees' actual discussions.

In addition to their duties to give information to members, trustees must also disclose information to the scheme actuary and the scheme auditor if that information is reasonably required by those advisers for the performance of their duties.

2.3 Trustees' rights to information

Equally, the trustees may ask the employers (and former employers) participating in the scheme for any information that the trustees or their professional advisers reasonably require in order to perform their duties. If something happens that the employer has reasonable cause to believe will be of material significance in relation to the functions of the trustees or their professional advisers, the employer must disclose that occurrence to the trustees.

2.4 Data protection

Under the EU General Data Protection Regulation (GDPR), trustees count as "data controllers" due to the large amount of personal member data they manage. This means that trustees must comply with the data protection principles set out in the GDPR. The GDPR principles include (but are not limited to) ensuring that personal data is:

- Processed fairly and lawfully and in a transparent manner.
- Processed only for specified, explicit and legitimate purposes.
- Adequate, relevant and limited to what is necessary for the processing.
- Accurate, and where necessary, kept up to date.
- Kept secure and confidential and not kept for longer than is necessary.

Data can be either "personal data" or "sensitive personal data". Personal data is basic information about individuals from which they can be identified, for example, their names, addresses and dates of birth. Sensitive personal data (now known as special category data) includes information relating to, for example, a person's health, sexuality, ethnicity or religion. Data controllers must generally obtain the explicit consent of an individual before processing sensitive personal data, unless one of certain other prescribed conditions in the GDPR is met. Trustees are likely to hold information about members' health and must ensure that this is treated as sensitive personal data and that the appropriate consent is obtained. Consent must be informed and freely given and can be withdrawn at any time. Trustees should be able to evidence that consent has been given.

Pensions administrators are likely to be data processors under the GDPR as they process data on the trustees' behalf. Data processors are subject to direct obligations under the GDPR in relation to the personal data that they process, but data controllers are also subject to a requirement to only appoint data processors who provide sufficient guarantees that they will put in place security and other measures to ensure that they process personal data in a way which meets the requirements of the GDPR. Trustees will therefore need to ensure that suitable provisions are included in their administration agreement.

As data controllers, trustees must provide certain information to the Information Commissioner (ICO) about how they handle personal data, and pay an annual fee to the ICO. The ICO uses the information provided to maintain a data protection register. Trustees must also put measures in place to ensure and be able to demonstrate that their data processing activities comply with the GDPR. Those measures will include:

- Carrying out a process to map how data is used by the scheme and its suppliers.
- Putting in place a data protection policy.
- Keeping records of data processing activities.
- Implementing appropriate security measures.
- Carrying out data protection impact assessments in certain circumstances.
- Where this is considered necessary, appointing a data protection officer.
- Issuing a privacy notice to members and any other data subjects in respect of whom the scheme holds personal data.

Measures should be reviewed regularly and updated if necessary.

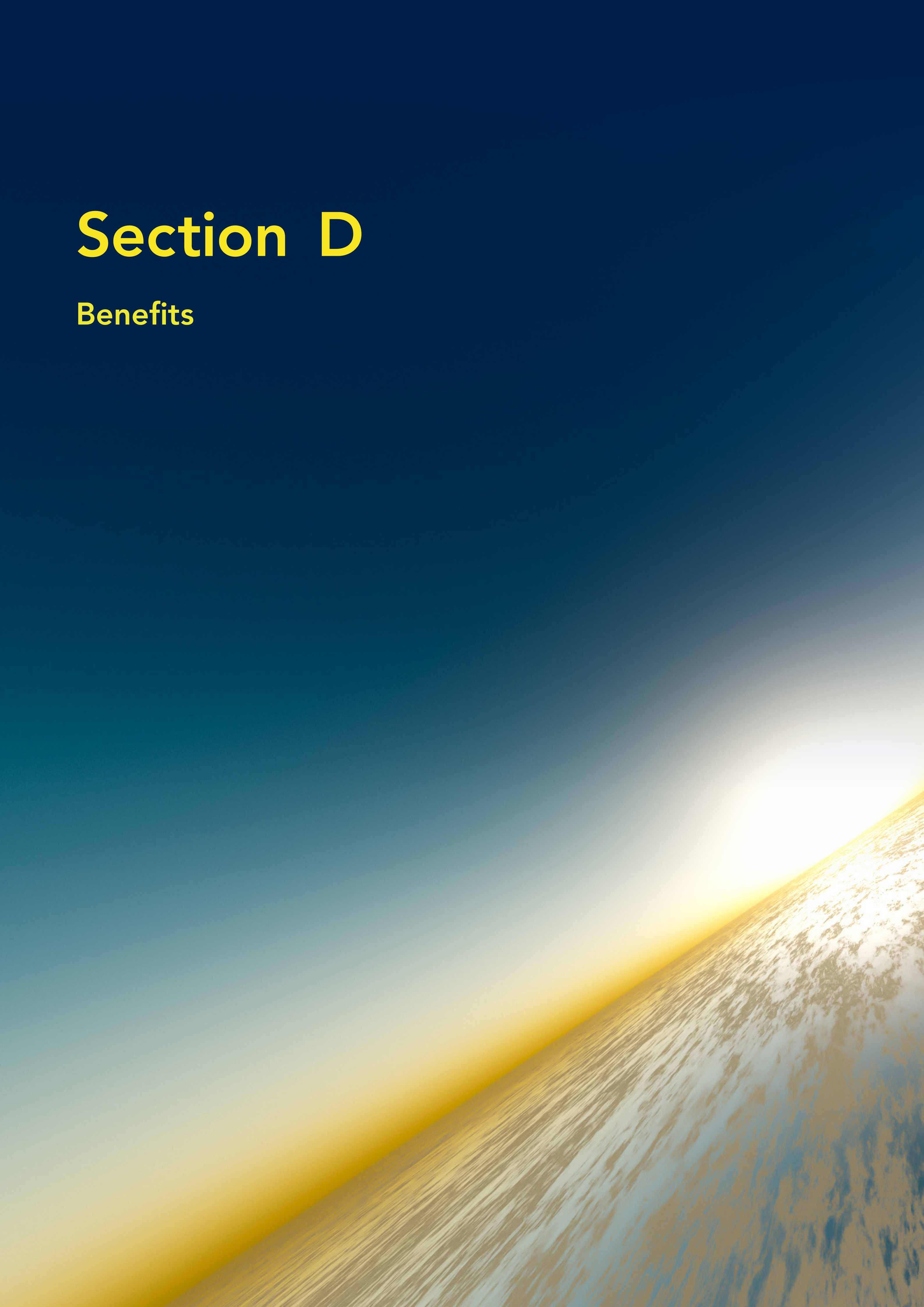
Personal data breaches (i.e. the unauthorised destruction, loss, alteration, disclosure or accessing of personal data) may have to be notified to the ICO and, in some circumstances, to the individual(s) to whom the data relates.

The ICO has a range of enforcement powers and sanctions under the GDPR. These include a power to fine a data controller up to EUR 20 million (or, for companies 4% of their worldwide turnover if greater) for breaching their data protection obligations.

Although the UK will be leaving the EU, the Data Protection Act 2018 enshrines the provisions of the GDPR in UK law.

2.5 Other records

Trustees must keep records of other key pieces of information (such as when members join, what benefits are paid, and transfers of assets into and out of the scheme) for at least six years.



Section D

Benefits

The days are long past when the employer that established a pension scheme could decide freely what benefits it was going to provide and what rights it was going to give scheme members. This Section looks at some key ways in which legislative requirements may override a scheme's trust deed and rules in these areas.

1. Trust deed and rules

The starting point for trustees, however, is to comply with the provisions of the scheme's governing documents – that is the scheme's trust deed and rules. The trust deed and rules set out key provisions about what the trustees can and cannot do (supplemented by pensions legislation), and also set out the balance of powers between the trustees and the main sponsoring employer (known as the "principal employer") in respect of making certain decisions.

2. Pension increases

The Pensions Act 1995 requires schemes to provide inflation-related increases on non-DC pensions in payment earned in service after 5 April 1997. These increases are now based on inflation as measured by the Consumer Prices Index, capped at 5% for pension earned before 6 April 2005, and capped at 2.5% for pension earned since then.

The Pensions Act 1995 also requires schemes to provide inflation-related increases on DC pensions in payment earned in service after 5 April 1997 where the pension came into payment before 6 April 2005. These increases are based on inflation as measured by the Consumer Prices Index, capped at 5%. Where a DC pension came into payment on or after 6 April 2005, no statutory increases are required.

A scheme's trust deed and rules may require different pension increases which must be applied if they are more generous than those required under legislation.

3. Early leavers

3.1 Preservation

Occupational pension schemes must offer early leavers the option of taking a "deferred" or "preserved" benefit under certain circumstances. This requirement applies to an early leaver with:

- Two or more years' qualifying service in a DB scheme or in a DC scheme if the member joined the scheme before 1 October 2015.
- 30 or more days' qualifying service in a DC scheme if the member joined the scheme on or after 1 October 2015.

"Qualifying service" is membership of the scheme plus membership of any scheme from which a transfer payment has been accepted in respect of the member. Such members must be entitled to a deferred benefit payable from the scheme's normal retirement age and calculated using the same formula as the benefit payable on retirement from service at that age. As such members are entitled to a deferred benefit, they cannot be given the option that applies to members with less than two years'/30 days' qualifying service (as applicable) of a refund of their contributions instead.

3.2 Revaluation

The revaluation legislation (contained in the Pension Schemes Act 1993) is intended to prevent early leavers' deferred pensions from losing too much of their value because of inflation. The revaluation requirement applies to the rights of members who leave pensionable service on or after 1 January 1986 where there is at least a year between the date of leaving and the member attaining their scheme's normal pension age. Legislation requires deferred benefits in excess of the guaranteed minimum pension (see paragraph 8.2 below) to be revalued from the date of leaving to the date of retirement. Benefits earned in pensionable service which ended prior to 1 January 1986 are not revalued unless scheme rules provide otherwise.

Different rules about revaluation apply to final salary, DC, flat rate and average salary benefits respectively. In most cases final salary benefits are revalued using the so-called "final salary method". The requirements have become highly complex in recent years, but in broad terms:

- Deferred final salary pensions earned before 6 April 2009 must be increased in line with inflation over the period of deferment (or by 5% compound over that period if less).
- Deferred final salary pensions earned since 6 April 2009 must be increased in line with inflation over the period of deferment (or by 2.5% compound over that period if less).

Inflation is now measured by the Consumer Prices Index. A scheme's trust deed and rules may set out a different method of revaluation. In those cases, the statutory method should normally be applied where that would lead to a bigger pension for the member.

4. Discrimination

UK legislation prohibits various forms of discrimination as they affect pension schemes. Discrimination may be:

- Direct (for example, treating a member less favourably than another member because of their sex or age).
- Indirect (for example, applying what appears to be a neutral provision, criterion or practice to a member which, even if it applies equally to all members, disadvantages one sex or age band more than another).

However, in general, indirect discrimination may be lawful if it can be objectively justified as a proportionate means of achieving a legitimate aim.

4.1 Sex discrimination

The main concern here is that many pension schemes used to have a retirement age of 65 for men and 60 for women, which discriminates against men.

As a result of the *Barber* and *Coloroll* judgments of the Court of Justice of the European Union, there is now a requirement that pension schemes should equalise the normal retirement age (NRA) for men and women, as regards pensionable service after 17 May 1990. The case of *Coloroll* established what is known as the "*Barber* window" – whereby schemes must level up benefits from 17 May 1990 (the date of the *Barber* judgement) until the date the scheme is amended to equalise the NRA.

This means that different NRAs can apply to different periods of pensionable service where, for example, a male member is entitled to draw his benefits accrued during the *Barber* window from age 60, but his retirement age is 65 for benefits that have accrued outside the *Barber* window.

Until recently, an issue which remained unresolved, well over 20 years after the *Barber* judgment, was the question of whether schemes are also required to equalise benefits for the effect of guaranteed minimum pensions (GMPs) (see paragraph 8.2 below). The rules governing the accrual and payment of GMPs are set out in legislation. Those rules differ as between men and women in a number of respects – in particular, GMPs are payable at age 60 for women and age 65 for men. While the *Barber* decision, and subsequent cases, established the broad principle that occupational pensions earned from 17 May 1990 must be equal for men and women, another series of court decisions established that state pensions do not have to be equal for men and women. It was not therefore clear whether:

- Benefits also had to be equalised for the effect of unequal GMPs (since GMPs are a replacement for a state pension benefit).
- If benefits had to be equalised, how this should be achieved (since the question of which sex has the higher overall benefit will differ from one case to another and may change over an individual's lifetime).

In October 2018, the High Court held in the *Lloyds* case that there is a requirement to equalise the age for payment of GMPs attributable to service between 17 May 1990 and 5 April 1997 (when GMPs ceased to accrue). The Court also provided guidance on how equalisation should be effected. However, a number of related issues remain unclear, and a further Court hearing is expected. Guidance is also expected from HM Revenue & Customs (HMRC) on the tax issues arising in connection with equalisation.

4.3 Discrimination against part-timers

It is unlawful to treat part-time employees less favourably than corresponding full-time employees as regards entry to, and benefits under, a pension scheme.

4.4 Discrimination against fixed-term workers

It is unlawful to treat fixed-term workers less favourably than workers on indefinite contracts as regards entry to, or benefits under, a pension scheme.

4.5 Discrimination on the grounds of sexual orientation

It is unlawful to treat employees less favourably in relation to a pension scheme on the grounds of their sexual orientation. In addition, the government introduced civil partnerships under the Civil Partnership Act 2004 and same sex marriage under the Marriage (Same Sex Couples) Act 2013. This legislation came into force on 5 December 2005 and 13 March 2014 respectively. One of its effects is that, where a member forms a civil partnership or enters into a same sex marriage, the surviving civil partner/same sex spouse must be given the same death benefits as the widower of a female member as regards contracted-out employment at any time, and as regards all benefits earned on or after 5 December 2005. However, in 2017, the Supreme Court held in the *Walker v Innospec* case that the legislative provisions allowing schemes not to pay equal death benefits for pre-5 December 2005 service were incompatible with EU law and must therefore be disapplied. As such, schemes are now required to pay the same death benefits to a surviving civil partner/same sex spouse as would be payable to an opposite sex spouse.

4.6 Disability discrimination

It is unlawful to exclude an employee from membership of a scheme on the grounds of the employee's disability alone. However, it may still be possible to restrict entitlement to some death in service or ill-health retirement benefits where it would be more expensive to provide such benefits due to the employee's medical condition.

4.7 Age discrimination

Age discrimination is unlawful as regards benefits accruing on or after 1 December 2006, unless it can be objectively justified or it falls within one of a series of "pensions exceptions" set out in regulations. For example, it would be direct age discrimination not to allow a member who remains in service after 65 to continue to accrue benefits (unless it can be objectively justified – there is no pensions exception which would authorise this practice). On the other hand, a DC scheme may be able to operate different contribution rates for members of different ages, because there is a pensions exception for this practice in some circumstances.

4.8 Maternity and other parental leave

Legislation also gives a series of pension rights to members who are on maternity leave or who take some other form of parental or adoption leave. The rules differ for different types of leave, and at different times during a single period of leave – for example, different rights apply during paid and unpaid maternity leave, with benefits normally having to be provided during paid maternity leave on the same basis as would apply to a normal active member, but with the member usually paying lower contributions. The full detail of the legislation is however beyond the scope of this Guide.

5. Tax

5.1 Tax relief

For many years, pension schemes have been subject to a favourable tax regime. This has included tax relief on member and employer contributions and on investment income and capital gains. It has also included the ability to commute part of a member's pension for a tax-free lump sum, and to provide a lump sum death benefit which, if paid subject to discretionary trusts, is free of income tax and inheritance tax.

However, after almost 100 years of stability in this area, these tax exemptions have been eroded since 1997 – initially just in terms of the tax relief on dividend income, but more recently by placing new limits on the level of pension accrual that benefits from tax relief.

5.2 Revenue limits

Before 6 April 2006 (A-Day), occupational pension schemes could obtain tax relief by being "approved" by HMRC (or the Inland Revenue as it was called then). It was a condition of such approval that the benefits provided were limited in various ways set out in legislation and in the Inland Revenue's "practice notes".

Broadly, these limits included a ceiling on member contributions of 15% of remuneration, a maximum member's pension of two thirds of final remuneration, a maximum lump sum payment on retirement of 150% of final remuneration, and a maximum lump sum death in service benefit of four times final remuneration (plus a refund of the member's own contributions to the scheme).

There was also an "earnings cap" for members who joined a scheme on or after 1 June 1989 which meant that, in calculating their contributions and benefits, remuneration above a prescribed "cap" had to be disregarded.

5.3 Tax "simplification"

From A-Day, tax relief is available to any "registered pension scheme". Details of the new tax regime are set out in the Finance Act 2004. Schemes which were "approved" immediately before A-Day automatically become "registered".

The new regime does not have "Revenue limits" like the previous regime. Instead it contains a concept of "unauthorised payments". The fact that a payment is unauthorised does not of itself prevent a scheme from making it. But if a benefit payment is unauthorised, there is a tax charge for the recipient and (probably) a further tax charge falling on the scheme itself.

Commutation of pension (i.e. giving up a pension in exchange for a tax-free lump sum on retirement) is still possible, but the commutation payment will be an unauthorised payment if it exceeds an amount prescribed in the Finance Act 2004. This amount is broadly designed so that the member will be able to commute up to 25% of his or her pre-commutation pension. (In some cases, a small pension may be commuted in full.)

In practice, many schemes which were "approved" immediately before A-Day retained "Revenue limits", but relaxed some of them (to allow greater tax-free cash to be paid, for example). At the same time, most such schemes decided that unauthorised payments could only be paid if the trustees and employer agreed.

As well as the tax charges on "unauthorised payments", the Finance Act 2004 introduced two further key tax charges. These are the lifetime allowance charge and the annual allowance charge.

(a) The lifetime allowance charge

The lifetime allowance charge is levied where the value of the member's benefits from all registered schemes (calculated on a basis prescribed in the Finance Act 2004) exceeds the member's lifetime allowance, which is £1.055 million for the 2019/20 tax year. As of 6 April 2018, the lifetime allowance is subject to annual inflation-linked increases (as measured by the Consumer Prices Index). Some individuals who have built up rights which exceed the lifetime allowance (or which are expected to exceed it after allowing for revaluation and/or investment return) have higher lifetime allowances. The arrangements which allow this are referred to as "primary protection", "enhanced protection", "fixed protection" and "individual protection", each of which works in a slightly different way. In all cases, however, the principle is that a tax charge arises when benefits exceed the member's lifetime allowance, which is designed to ensure that pension saving beyond that level is not tax-efficient.

(b) The annual allowance charge

The annual allowance charge is levied where the growth in value of the member's benefits over any tax year (expressed as 16 times the pension accruing in the case of a DB scheme or the amount of contributions paid by or in respect of the member in the case of a DC scheme) exceeds the annual allowance. A carry-forward mechanism allows people to utilise unused annual allowance from broadly the past three tax years. This is intended to ensure that the annual allowance charge is rarely triggered simply as a result of a one-off pay increase or the like.

For the 2019/20 tax year, the annual allowance is £40,000. Members with DC and cash balance benefits who have accessed those benefits may be subject to a reduced annual allowance of £10,000 for any future DC accrual. In addition, since 6 April 2016, a "tapered" annual allowance has applied to individuals broadly earning £150,000 or more. Essentially, the annual allowance is reduced from £40,000 by £1 for every £2 over the £150,000 threshold that the individual earns, down to a minimum of £10,000.

Where an individual incurs an annual allowance charge of more than £2,000, they can, in certain circumstances, require the pension scheme to pay this tax charge on their behalf, with a resulting adjustment to their benefits under the scheme. This is known as the "scheme pays" regime.

6. Transfers

6.1 Transfer rights

A transfer value is the amount which a member of a pension scheme is able to "transfer out" to another registered pension scheme in order to acquire rights under that scheme instead. The transfer value ordinarily represents an actuarial assessment of the capital value of the member's benefits in a DB scheme, or the realisable value of the member's benefits in a DC scheme.

A member of an occupational pension scheme has a statutory right under the Pension Schemes Act 1993 to request and take a "cash equivalent transfer value" (CETV) of his or her benefits. The Pension Schemes Act 1993 divides benefits into three different categories, and gives members a separate transfer right in respect of each category of benefit. The three categories are:

- Salary-related benefits (e.g. final salary and CARE benefits) – a member has a statutory right to transfer these benefits until 12 months before the scheme's normal pension age.
- DC benefits – a member has a statutory right to transfer these benefits until those benefits are first crystallised (this happens when the member starts to draw a pension in respect of those benefits, designates them for drawdown (see paragraph 10 below), or uses them to purchase an annuity).
- Other flexible benefits (essentially cash balance benefits) – a member has a statutory right to transfer these benefits until those benefits are first crystallised.

Members holding more than one type of benefit may therefore have different statutory transfer rights in relation to different tranches of their benefits. If a member holds two different categories of benefit and make a statutory transfer request in respect of one category, he or she cannot be required to transfer the benefits in the other category also. However, a statutory transfer request can only be made in respect of all the benefits in a particular category. Schemes can offer members additional non-statutory transfer rights under the scheme's trust deed and rules.

Members who have completed three months' pensionable service in a DB scheme may also transfer their benefits out of the scheme as an alternative to having a refund of contributions.

Where the benefits in question are non-DC benefits, the trustees must provide the member with a "statement of entitlement" i.e. a written statement of the amount of the CETV at the "guarantee date" of the benefits which have accrued to or in respect of the member under the scheme. The trustees are responsible for determining the amount of the transfer value, and in some cases the transfer value may need to be reduced to reflect scheme underfunding.

Members wishing to transfer "safeguarded" benefits (broadly, salary-related benefits and benefits with a guaranteed annuity rate) to a scheme which will provide DC or cash balance benefits must take advice on the proposed transfer from an independent financial adviser (IFA) authorised by the Financial Conduct Authority (FCA) if the CETV of the member's safeguarded benefits is more than £30,000. Trustees must receive confirmation from the IFA that the member has taken advice, and must check that the IFA's firm is appropriately authorised by the FCA. Trustees are not required to check the substance of the advice. The member is required to pay for the advice, unless the transfer request is the result of an employer-led exercise, in which case the employer is required to pay for the advice. In addition, as of 6 April 2017, where a member wishes to transfer "safeguarded-flexible" benefits (essentially, benefits with a guaranteed annuity rate), the trustees must provide certain risk warnings.

The ways of taking a transfer value may include acquiring transfer credits in another occupational pension scheme, or acquiring rights in a personal pension scheme – provided in all these cases that the receiving arrangements are registered in accordance with the Finance Act 2004 and are willing to receive the transfer payment. In some cases transfers are permitted to overseas schemes, although this may trigger a 25% tax charge for the member. The transfer value may also be used to purchase an annuity with an insurer.

In most cases, transfers require the consent of the member, but there are restricted circumstances (prescribed by legislation) where a group of members can be transferred to another occupational pension scheme without requiring member consent.

6.2 Pensions liberation and pension scams

In recent years, an increasing number of pension transfers have been linked to what is known as "pensions liberation" or pension scams. Pensions liberation is where a member is offered the chance to transfer benefits into a new arrangement, for a fee, and then to take those benefits before normal minimum pension age (NMPA) (which is typically age 55 currently) and/or to take more of his or her benefits than are ordinarily permitted as cash. It is not necessarily "illegal" to draw benefits before NMPA. But unless the member is suffering from ill-health, it is likely to amount to an unauthorised payment. However, such behaviour may amount to fraud if members are dishonestly misled into making the transfer. Alternatively, a pension scam may involve the member being encouraged to transfer with the promise of higher investment returns in the receiving scheme. The transferred funds are then invested in inappropriate investments and the member usually loses all or a significant amount of his or her savings.

A common problem faced by trustees is what to do when they receive a request for a transfer that appears to be pensions liberation or a pension scam. The Pensions Regulator has recognised this as an issue, but has offered limited support for trustees who wish to protect members. Separately, HMRC has put in place stricter controls over which schemes may be established and run as registered pension schemes. There

have also been a large number of complaints by members to the Pensions Ombudsman in relation to pensions liberation. The Ombudsman's view would appear to be that, if a member has a transfer right (whether under legislation or under the trust deed and rules), trustees must comply with the transfer request, even if they suspect that the receiving scheme is a liberation vehicle. Trustees should, however, make members aware of the risks associated with pensions liberation and pension scams.

7. Additional voluntary contributions

As well as paying ordinary contributions, schemes may allow members to pay additional voluntary contributions (AVCs) to supplement their benefits. As a result of changes made by the Pensions Act 2004, trustees are no longer obliged to offer an AVC facility to active members, but many schemes have continued to offer this facility. Some schemes have also removed the old Revenue limits which restricted the amount of contributions that could be made to AVCs and may also allow members to take a lump sum from their AVC pot as part of taking a tax-free "pension commencement lump sum" under the Finance Act 2004.

8. Contracting-out

8.1 State pensions and contracting-out

Prior to 6 April 2016, the State pension was in two parts – the Basic State Pension which was a flat-rate universal pension, and a second tier which took different forms over the years. From 1961 to 1975, this second tier was known as the State Graduated Scheme. From 1978 to 1997, it was the State Earnings-Related Pension Scheme or SERPS and, between 1997 and 2016, the system was known as the State Second Pension or S2P. From 6 April 2016, a new State pension regime has been introduced for all individuals reaching State Pension Age from that date. Essentially, the previous two tier system has been replaced by a flat-rate single tier pension.

"Contracting-out" was a process by which an occupational scheme took over responsibility for providing all or part of the pension which would otherwise have been provided by the second tier of the State pension. As a result, members of that scheme and their employers were allowed to pay lower National Insurance contributions. Contracting-out was abolished from 6 April 2016 as a result of the move to a single tier State pension.

8.2 Equivalent pension benefits and guaranteed minimum pensions

From 1961 to 1975, schemes could contract out of the State Graduated Scheme by providing "equivalent pension benefits" (EPBs), but as these relate to service before 6 April 1975, it is now uncommon to come across EPBs in practice. Because EPBs were not inflation-protected, they are in practice often very small and, in view of that, the special legislation which used to apply to them has gradually been repealed. By and large, EPBs have simply been subsumed within the pensions that were otherwise payable from the scheme.

From 6 April 1978, a DB scheme could contract out by providing members and their widows or widowers (including, nowadays, same sex spouses and civil partners) with a minimum level of pension known as the guaranteed minimum pension or GMP. This form of contracting-out ceased on 5 April 1997 and no one has accrued a GMP since that date. However, the terms on which GMPs had to be provided mean that GMP rights can still have a real effect on members' pensions. GMPs, and the rules on their treatment, continue to exist following the April 2016 abolition of contracting-out. There have been some changes to the rules on the treatment of GMPs post-abolition of contracting-out, in particular in relation to the revaluation of GMPs.

8.3 Reference scheme test

Between 6 April 1997 and 5 April 2016, it was possible for a DB scheme to contract out by obtaining a certificate from its actuary that its retirement and death benefits were broadly equivalent to, or better than, the benefits that would be provided by a notional "reference scheme". Many DB schemes were contracted-out using this "reference scheme test".

This form of contracting-out was abolished from 6 April 2016. Accrued contracted-out rights however remain in place, with the vast majority of the pre-6 April 2016 rules on how such rights must be treated continuing to apply post-abolition.

8.4 Protected rights

Between 6 April 1988 and 5 April 2012, it was also possible for schemes to contract out by providing "protected rights" which were a form of DC benefit. Certain contributions had to be paid into a member's DC "protected rights" account, and the pot of money that resulted had to be used in particular ways laid down in legislation on the member's retirement or death.

This form of contracting-out was designed for DC schemes, but some DB schemes also contracted out on the protected rights basis by providing protected rights benefits as an underpin to their DB benefits.

This form of contracting-out was abolished with effect from 6 April 2012. Trustees had a statutory power to convert accrued protected rights into ordinary scheme benefits – this power expired on 5 April 2018.

8.5 Buying back into the State scheme

Where a member ceased to be in pensionable service before completing at least two years' qualifying service, it was normally possible to extinguish the member's contracted-out rights by paying a contributions equivalent premium to the State scheme. This premium was basically equal to the saving made in the member's and the employer's National Insurance contributions due to the fact that the member was contracted-out.

9. DC governance

Over recent years, with the closure of many DB schemes and the introduction of automatic enrolment (see paragraph 11 below), membership of DC schemes has increased significantly, leading to a greater focus on the governance of such schemes. In 2013, the Regulator published a code of practice on the governance and administration of DC occupational pension schemes, and in April 2015, statutory minimum governance standards were introduced specifically for DC schemes for the first time. The Regulator's code of practice was reviewed in light of the new statutory standards, and a revised version came into force in 2016. A flowchart setting out which elements of the statutory DC governance provisions and the Regulator's code of practice apply to which schemes can be found at the end of this Guide.

9.1 Charges

Charges in default arrangements in occupational pension schemes that are "qualifying schemes" for automatic enrolment purposes (see paragraph 11 below) must be structured in one of three permitted ways, and must not exceed an annual cap. This restriction applies to qualifying schemes that provide DC benefits (other than schemes whose only DC benefits are AVCs). Where charges are a percentage of funds under management, the cap is 0.75%. Different caps apply where one of the two other permitted charging structures is used. The definition of "default arrangement" includes not only traditional default arrangements to which contributions are allocated if the member does not choose an investment option, but also, where members have made an investment choice, funds to which 80% of contributing members of the scheme were or are contributing on or after 6 April 2015.

Active member discounts (i.e. arrangements under which deferred members pay higher charges than active members) have been banned in all qualifying schemes providing DC benefits (including DB qualifying schemes that provide DC AVCs) from 6 April 2016.

A ban on member-borne commission payments in qualifying schemes also came into force in April 2016. Again, this ban applies to all qualifying schemes providing DC benefits, including DB schemes providing DC AVCs. The ban originally applied to new member-borne commission arrangements entered into on or after 6 April 2016, but was extended to cover all arrangements in October 2017. It is the scheme's service providers, rather than the trustees, who are required to comply with the ban, but trustees must notify their service providers that the scheme is a qualifying scheme. This ban covers any remaining consultancy charging arrangements in place (most such arrangements have been banned since May 2013).

In addition, a cap on early exit charges in occupational pension schemes (whether or not a qualifying scheme) providing DC benefits (including DC AVCs in a DB scheme) was introduced in October 2017.

9.2 Governance standards

All occupational pension schemes providing DC benefits (unless exempt) are required to appoint a chair of trustees if they do not already have one. The chair will be required to sign off an annual statement containing certain information on the scheme's default arrangement(s) and on member-borne charges and transaction costs, and confirming that certain minimum governance standards have been met in relation to the scheme. The statement must be included in the scheme's annual report. Schemes must also publish those sections of the statement that relate to the default arrangement(s) and to member-borne charges and transaction costs free of charge on a website.

The other minimum governance standards include requirements to:

- Prepare a statement of investment principles in respect of the scheme's default arrangement(s) covering various prescribed matters.
- Review certain aspects of the default arrangement(s) at least every three years and revise the statement of investment principles as appropriate.
- Calculate the scheme's member-borne charges and transaction costs and assess the extent to which they represent good value for members.
- Process core financial transactions (including the attribution of contributions to the relevant funds) promptly and accurately.

9.3 AVC arrangements

Generally speaking, the governance standards and most of the charging restrictions (with the exception of the bans on active member discounts and member-borne commission payments and the cap on early exit charges) do not apply to DC AVC arrangements in DB schemes. However, there are exceptions to this.

10. Taking DC and cash balance pots on retirement

Until April 2015, when a member of a DC or cash balance pension scheme retired, there were two main ways in which the member could take his or her benefits.

- *Annuity purchase*

  The member's DC/cash balance pot could be used to purchase an annuity from an insurer. The amount of the annual pension provided by the annuity depended on a number of factors, including the value of the member's pot at the time of retirement and the terms of the annuity policy.

- *Scheme pension*

  The member's DC/cash balance pot could be used to provide a pension from the scheme. In other words, the member's DC/cash balance benefits were converted into a defined benefit. Actuarial advice was required to determine the level of annual pension which the scheme would provide, and this level again depended on factors such as the value of the pot and the actuarial assumptions used.

Where an annuity was purchased, the scheme ceased to be liable to provide benefits to the member. Where the scheme provided the pension, the scheme remained liable to provide the member's pension, even if the member's pot proved to be insufficient to provide the promised level of pension. Most DC and cash balance schemes therefore preferred to use the annuity purchase route. Under both routes, members could take 25% of their pot as a tax-free pension commencement lump sum.

However, from 6 April 2015, greater flexibility has been introduced in the way in which members can use their DC and cash balance pots. It still remains possible to use some or all of a DC/cash balance pot to purchase an annuity from an insurer or to provide a scheme pension, as described above. However, in addition, a member can access his or her pot in one or more of the following ways.

- *Flexi-access drawdown*

  A member can designate some or all of his or her DC/cash balance pot for flexi-access drawdown. The pot (or the designated part of it) is then left invested in the scheme, and the member can draw it in the form of one or more lump sums as and when he or she wishes, rather as if it were a bank account (subject to any restrictions applied by the scheme). Withdrawals are taxed at the member's marginal rate, and a tax-free pension commencement lump sum can still be taken (but only at the point of designation).

  Two forms of drawdown were permitted prior to April 2015, but there was a cap on the amount of cash that could be withdrawn unless the member had at least £12,000 of additional pension income from other sources. These restrictions do not apply to flexi-access drawdown.

- *Uncrystallised funds pension lump sum*

  A member can take all or part of his or her DC/cash balance pot as an uncrystallised funds pension lump sum (UFPLS). A member can take multiple UFPLSs or can withdraw his or her entire pot in a single payment (subject to any restrictions applied by the scheme). An UFPLS cannot be taken from funds designated for flexi-access drawdown. 25% of each UFPLS is tax-free, with the remainder being taxed at the member's marginal rate.

Schemes are not required to offer any of the above new ways of accessing DC/cash balance benefits, but have a statutory power to do so. Should a scheme wish to offer one or more of the new options, the trustees can choose to impose restrictions on the use of the option – for example, limiting the number of UFPLSs that a member can take. Members can currently access their DC/cash balance benefits from age 55.

11. Automatic enrolment

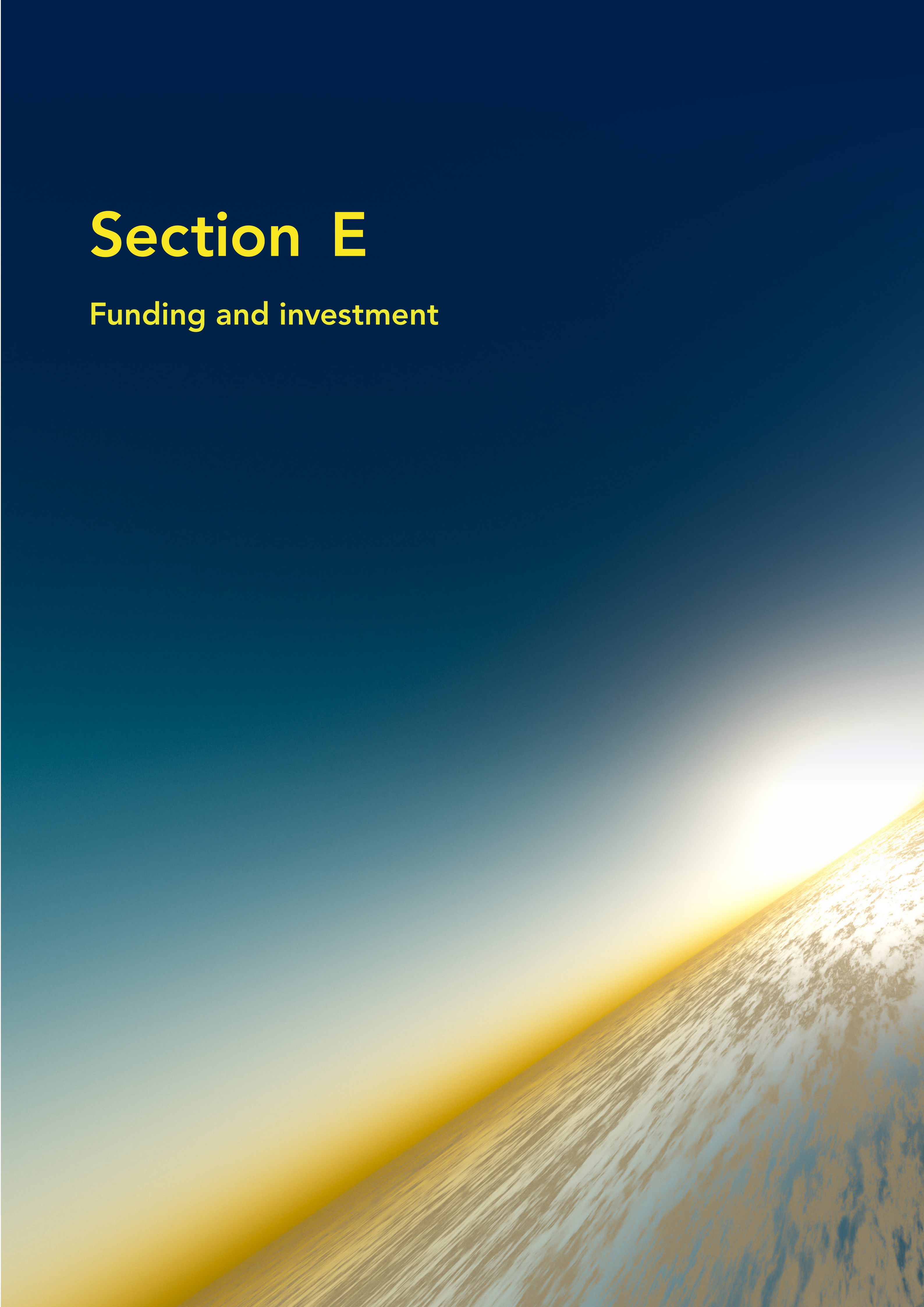
The automatic enrolment regime was introduced in October 2012, and requires employers to automatically enrol most workers into a "qualifying scheme" and to give certain other workers the right to opt into automatic enrolment or join a registered pension scheme. The enrolment duty applies to an employer from its "staging date" – a date somewhere between 2012 and 2017, depending on size of the employer's April 2012 payroll (the larger the payroll, the earlier the staging date). All employers in the UK are now subject to the enrolment duty. Workers who have been automatically enrolled have a statutory right to opt out within one month.

A "qualifying scheme" must meet certain prescribed quality requirements. A DB scheme must:

- be contracted-out (this was only possible until April 2016);
- satisfy a statutory "test scheme standard"; or
- meet prescribed requirements regarding the cost of funding future accrual.

A DC scheme must have a contribution rate structure which meets one of four alternative minimum contribution rate structures. These minimum contribution rates were phased in between October 2012 and April 2019.

As automatic enrolment is an employer duty, it is really only relevant to trustees if their scheme is being used as a qualifying scheme.



Section E

Funding and investment

1. DC schemes versus DB schemes

In a DB scheme, members are promised a pension calculated on a specified basis, and the employer is responsible for ensuring that there are sufficient funds in the scheme to provide the promised pensions. The employer therefore bears the funding and investment risk. Assets in a DB scheme are invested for the benefit of the scheme as a whole, and the trustees determine how the assets are invested – individual members do not have any control over the scheme's investments.

In a DC scheme, members are (usually) promised a specified level of employer contributions and required to pay a specified level of contributions themselves. The pension they receive is determined by the value of their pension pot at retirement. The individual member therefore bears the funding and investment risk. Contributions to a DC scheme are invested for the benefit of the member by whom and in respect of whom those contributions were made. Whilst the trustees determine the range of investment options that are available to members, it is usually the individual members who decide how their contributions should be invested among those options.

2. Investment

2.1 Scope of the power to invest

The Pensions Act 1995 says that trustees are entitled to invest scheme assets as if those assets were the trustees' own property (unless there is a restriction in the scheme provisions). Any provision in the scheme's trust deed which requires the trustees to obtain employer consent before investing has no effect.

Having said this, there are some significant restrictions on trustees' investment powers:

- The assets must be invested in the best interests of members and beneficiaries (or, in the case of a potential conflict of interest, in the sole interest of members and beneficiaries).
- The power to invest must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole.
- The investments must be suitable and diversified, meaning that they must consist predominantly of investments traded on regulated markets, with derivatives only being used to reduce risk or for the purposes of efficient portfolio management[1].
- The investments must give effect to the statement of investment principles (see paragraph 2.4 below).
- Trustees may borrow money or act as guarantor only where the aim is to provide liquidity for the scheme on a temporary basis.
- No more than 5% of a scheme's resources may be invested in employer-related investments (including shares issued by the employer or land or other property used by the employer, amongst other things). There is also a ban on investing in employer-related loans.

2.2 Decision-making

Legislation requires the day-to-day investment management of pension scheme assets to be carried on by a person who is authorised or exempt under the Financial Services and Markets Act 2000. Pension scheme trustees do not have to be authorised where all day-to-day decisions in relation to the investment of the scheme's assets are taken on their behalf by an authorised person.

1 Derivatives may be used for the purposes of efficient portfolio management where their use enables an investment strategy to be effected more flexibly or more economically without any corresponding significant increase in investment risk.

Trustees are therefore expected to delegate day-to-day investment decision-making to an authorised investment manager. There is an exception for investment in pooled funds and insurance policies, but appropriate investment advice must be taken.

Trustees do have power to take strategic decisions, for example, about allocations to differing asset classes and decisions affecting the balance between income and growth assets. Trustees enjoy certain statutory protections if they obtain appropriate written investment advice from a knowledgeable person when taking these strategic decisions.

Where the trustees are giving specific instructions, for example, regarding a particular investment, or are giving instructions on a regular basis, this may not be regarded as a strategic decision and caution is required. There are detailed requirements set out in legislation which must be met before trustees can do this.

Case law demonstrates that trustees can make poor investment decisions without being liable for the lost performance. However, the trustees do have to invest in the best financial interests of beneficiaries (including the employers, who have an interest in investment performance because they pay the costs of the scheme). Generally speaking, only if investments are of equal financial merit can ethical or other non-financial considerations be taken into account. However, trustees can (and should) take into account any factor which could have a financially material impact on the risk and/or return associated with an investment – such considerations would include any relevant environmental, social or governance (ESG) factors. From October 2019, trustees will be required to have a documented policy on how financially material considerations such as ESG factors are taken into account in investment decision-making.

2.3 Delegation and liability

Trustees may (and frequently do) delegate investment decisions to a sub-committee. The legislation also allows trustees to delegate any investment decisions to fund managers who are able to take such decisions without breaching UK financial services legislation.

In practice, investment is almost always delegated to an investment manager. The law nevertheless requires that the trustees retain overall responsibility for investment strategy and supervising the performance of investments.

The general rule under the legislation is that liability for breaching legal obligations to take care or exercise skill in exercising investment functions (whether by the trustees or someone to whom they delegate) cannot be excluded or restricted. However, trustees are not responsible for the acts or defaults of any fund manager to whom they delegate discretion if they take all reasonable steps to satisfy themselves that the manager has the appropriate knowledge and experience and is carrying out its work competently.

2.4 Statement of investment principles

The Pensions Act 1995 requires trustees to draw up a statement of investment principles (SIP). The SIP must be reviewed every three years or after any significant change in investment policy. The SIP cannot be drawn up or revised unless the trustees first obtain written advice from someone with appropriate knowledge and experience, and consult the employer. The legislation sets out the matters that need to be covered in the SIP, such as investment risks, the expected investment return, and the extent to which social, environmental or ethical considerations are taken into account. Changes to the matters that must be covered in the SIP will come into force in October 2019.

3. Funding DB schemes

3.1 Valuations

Under the Pensions Act 2004, actuarial valuations must be obtained by trustees of DB schemes at least once a year, unless they get actuarial reports for each intervening year, in which case the valuations can be produced once every three years.

When drawing up an actuarial valuation, the actuary will need to certify that the calculation of the amount needed to meet the scheme's liabilities is made in accordance with the relevant legislation and any applicable guidance. The valuation must also set out the actuary's estimate of whether there are enough assets to buy annuities covering liabilities in relation to members' and survivors' benefits.

The trustees must make available to the employer any actuarial valuation or report (whether or not it is obtained under the Pensions Act 2004) within seven days of their receiving it.

3.2 Scheme funding regime

"Scheme-specific" funding requirements under the Pensions Act 2004 came into force in 2005 and apply to most DB occupational pension schemes. The statutory scheme funding regime allows trustees to take account of their scheme's circumstances when determining the funding for their scheme.

A key concept underpinning the scheme specific funding regime is the "statutory funding objective". This requires that schemes have sufficient and appropriate assets to cover their "technical provisions". A scheme's "technical provisions" are the value of its liabilities as calculated by the scheme actuary.

Trustees must:

- Prepare a statement of funding principles (SFP) (setting out how the trustees plan to meet the statutory funding objective, amongst other things).
- Obtain actuarial valuations and reports.
- Put together a schedule of employer and employee contributions (which the scheme actuary must certify is consistent with the statement of funding principles).
- Draw up a recovery plan if the statutory funding objective is not met (setting out the steps to be taken to meet the statutory funding objective and the period within which this will be achieved).
- Issue annual summary funding statements to members and beneficiaries.

3.3 Balance of power

Under the scheme funding regime, a scheme must have enough assets to make provision for its liabilities. Trustees will have to decide the SFP, the methods and assumptions to be used in calculating the technical provisions, the schedule of contributions and, if there is a deficit, the recovery plan. They must take actuarial advice on all these matters.

Generally, the trustees will need to **agree** the SFP, the methods and assumptions for calculating the technical provisions (which must be included in the SFP), the schedule of contributions, and any recovery plan with the employer. As an exception, where the scheme provisions give the trustees a unilateral power to set contributions and the employer has no power to reduce or suspend its contributions, then the

trustees only need to **consult** the employer. If the scheme provisions give the actuary a unilateral power to set the contributions, the actuary must certify that the rates shown in the schedule of contributions are not lower than those that the actuary would have provided for if the actuary, rather than the trustees, had the responsibility for preparing or revising the schedule.

If the trustees and employer are unable to agree, or the actuary is unable to certify the schedule of contributions, then the matter must be reported to the Pensions Regulator who ultimately has a range of powers, including power to set a schedule of contributions, or impose a recovery plan.

The Regulator has produced a code of practice on DB funding which recommends that trustees and employers work together in an open and transparent manner, and that trustees seek appropriate funding which reflects a reasonable balance between the need to pay the promised benefits and minimisation of any adverse impact on the employer's sustainable growth. Trustees should also manage funding, investment and employer covenant risks in an integrated manner which takes account of how those risks interact with, and impact on, each other (see Section C, paragraph 1.2(c)).

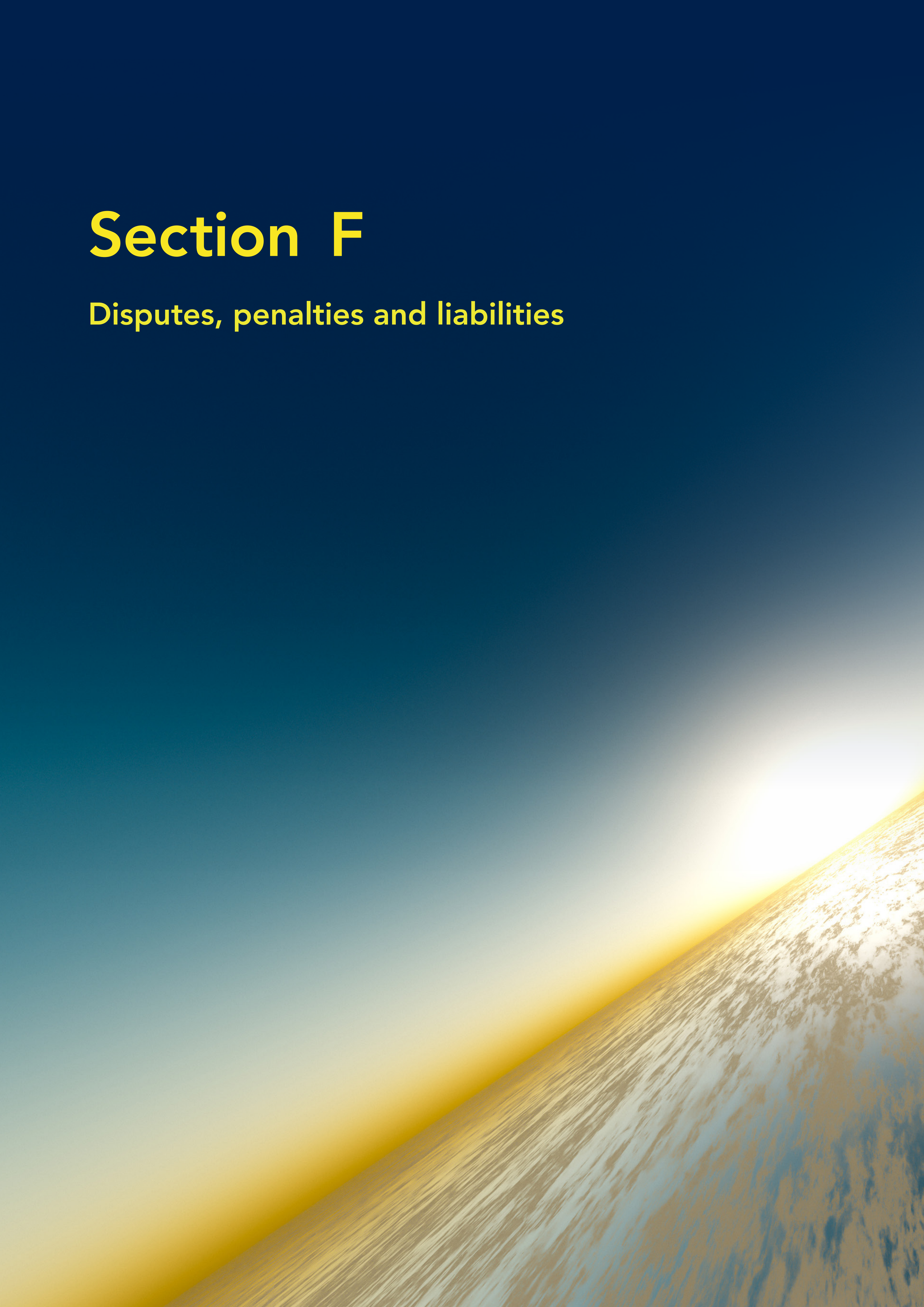
In March 2018, the government announced that the Regulator will issue a revised code of practice on DB scheme funding. Some or all of the funding standards contained in this revised code will be given statutory force, and the government will introduce a requirement for DB pension schemes to appoint a trustee chair and for the chair to report to the Regulator on key funding decisions by submitting a chair's statement with the scheme's triennial valuation. The Regulator plans to consult on the revised code of practice during the course of 2019, but the timetable for introduction of the legislative changes is unclear.

4. Employer covenant

The employer covenant is the employer's legal obligation and financial ability to support the scheme now and in the future. It is therefore an essential element for trustees of DB schemes to bear in mind throughout the scheme's lifetime, but in particular in relation to the scheme's funding and investment. As set out in paragraph 3.3 above, the Regulator considers that trustees of DB schemes should adopt a process of "integrated risk management" whereby they take funding and investment decisions based on the ability of the employer to support the scheme.

The Regulator expects DB schemes to assess their employer covenant (including how it may change in future), to monitor it regularly, and to document the assessment and monitoring process and its conclusions. Where employer covenant risks are identified, the Regulator expects trustees to put in place appropriate contingency plans. The Regulator recognises that assessment and monitoring of the employer covenant should be proportionate to the circumstances of both scheme and employer, including the degree of reliance of the scheme on the employer (now and in the future), and the complexity of the employer's operations.

Many schemes now appoint professional covenant assessors to advise them in relation to their scheme's employer covenant. The Regulator has published guidance on assessing and monitoring the employer covenant which includes an explanation of how trustees should conduct an assessment of the employer covenant if doing it themselves, as well as considerations when appointing a professional covenant advisor.



Section F

Disputes, penalties and liabilities

Errors can occur even in the best-run schemes, sometimes because something is simply overlooked, but sometimes just because a scheme's legal obligations are not entirely clear and a Court or the Pensions Ombudsman decides that the scheme has misunderstood them. Of course, disputes sometimes arise even when the scheme has been administered perfectly, because a member may think something has gone wrong when it has not.

This Section discusses disputes and the protections available to trustees (or directors of a corporate trustee) to ensure that they do not become personally liable as a result of an error.

1. Internal dispute resolution procedure

Occupational pension schemes (with some exceptions) are required by law to have an internal dispute resolution procedure (IDRP).

1.1 Who can use the procedure?

The scheme's IDRP has to be available to handle any dispute between the trustees of the scheme on the one hand and any:

- Active, deferred or pensioner member.
- Surviving spouse/civil partner/dependant of a deceased member.
- Prospective member.
- Person who fell within any of the above categories in the six months before the complaint.
- Person who claims to fall within the above categories.

The requirement to follow an IDRP does not apply where proceedings have started in a Court or tribunal or where the Ombudsman is already looking into the matter.

1.2 What will the procedure involve?

The IDRP may have two separate stages, with a specified person (other than a trustee) undertaking the first stage decision, with an appeal to the trustees at the second stage. Alternatively, a simpler one stage IDRP may be adopted, with a decision by the trustees straight away (which may be more appropriate for some schemes). The IDRP may allow decisions of the trustees to be taken on their behalf by one or more of their number.

A scheme's IDRP must ensure that decisions are reached, and notified to applicants, within a "reasonable period", which the trustees can set of their own accord. The Pensions Regulator's code of practice on reasonable periods provides that the relevant decision-maker is expected to determine disputes within four months of an application being made. If a single stage process is adopted, this time limit will apply to the entire process. If the IDRP has two stages, the four month period will apply to each stage. The applicant should be notified of the decision within 15 working days of the decision being reached. Shorter timescales for the determination and notification process can be adopted if desired.

Certain information must be sent to complainants when responding formally to their complaints, including a reminder that they can complain to the Ombudsman if they are not satisfied with the response.

2. Pensions Ombudsman and maladministration

The Ombudsman investigates and decides complaints and disputes about how pension schemes are run. The Ombudsman's decision is binding on the parties to the complaint or dispute and can be enforced in the Courts. Having said this, his decision can be appealed to the High Court on a point of law.

The Ombudsman may deal with a broad range of complainants, including members and former members (and their spouses/civil partners/dependants), anyone claiming to be any of those people, and trustees and employers. Complaints may be made against trustees (even by fellow trustees), employers, or scheme administrators, amongst others. But in reality virtually all complaints are brought by members, former members and their survivors.

The Ombudsman will not deal with complaints or disputes which are already before the Courts, or in relation to financial services or State pensions. Complaints should go through the scheme's IDRP before going before the Ombudsman, but the Ombudsman may, in some circumstances, hear a complaint even though the IDRP has not been completed.

The Ombudsman will generally consider a complaint brought by a member, former member or survivor only if it alleges both maladministration and injustice (i.e. some harm to the complainant which results from the maladministration). Trustees and employers do not have to allege injustice. Disputes can be disagreements concerning fact and/or law.

Maladministration does not have a statutory definition, but as well as covering failure to pay the right benefits, it has been described as including "bias, neglect, inattention, delay, incompetence, ineptitude, perversity, turpitude, arbitrariness and so on".

If the Ombudsman finds against the trustees, this can result in the Ombudsman ordering the trustees to make a benefit payment which the trustees otherwise would not have made. The Ombudsman can also award compensation for non-financial injustice such as distress and inconvenience caused to the complainant by the maladministration. Such awards will generally range from £500 – £2,000, but may be higher in exceptional cases.

3. Types of claim that can be made

While the Ombudsman's powers to make awards for "maladministration" may not require the trustees actually to have breached the law, the majority of disputes which go to the Ombudsman or the Courts do in fact involve an allegation that the trustees have failed to comply with some legal obligation – whether arising under the scheme's trust deed and rules, general trust law or legislation.

3.1 Breach of trust

As already described, trustees' main duties are to act in accordance with the trust deed and rules, and to comply with the requirements of trust law and pensions legislation. When exercising discretions, trustees are required to act fairly and honestly, to take account of all relevant factors, and to ignore anything which is irrelevant.

If a breach of these duties leads to a loss by beneficiaries or by sponsoring employers which cannot be made good, the beneficiaries or employers may bring a claim for breach of trust. If it is found that a trustee has been in breach of trust after the trustee has ceased to be a trustee of the scheme, the trustees then in office could bring a claim against the former trustee. In an extreme case, a Court will allow beneficiaries to bring a claim in the name of the scheme against a current trustee.

In some cases, claims can be met out of the scheme's assets, but there will be other cases where claims could be made against the personal assets of the trustee who is in breach of duty.

3.2 Underpayment

A claim could be made where a benefit due under the trust deed and rules is underpaid (or not paid at all). In practice, such an underpayment would usually be made good with a correcting payment from the scheme's assets. The trustees are therefore not likely to face personal liability for underpayments. There is no statutory limitation period that applies to claims by beneficiaries in respect of underpayments (although a beneficiary cannot normally make such a claim more than six years after the winding-up of the scheme has been completed). A limitation period may, however, apply under the scheme rules.

3.3 Overpayment

Where a beneficiary has been paid more than he or she is entitled to under the trust deed and rules or where payment is made to a person who is not properly a beneficiary at all, and the trustees seek to recover the overpayment, the recipient of the overpayment could complain to the Ombudsman.

The starting point is that, in principle, trustees are obliged to pay benefits in accordance with the trust deed and rules and legislation and therefore to recover any overpayments (and, where applicable, to correct any future pension payments). However, a Court or the Ombudsman will prevent trustees from claiming repayment where the recipient has acted to his or her detriment in reliance on the overpayment being made (for example, he or she has made spending commitments in the expectation of receiving the overpayment) or has spent the money so that it would cause hardship if he or she had to make repayment now. The Ombudsman could also say that failure to reclaim overpayments promptly or a heavy-handed approach to claiming repayment is "maladministration", and award the recipient of the overpayment compensation for the distress and inconvenience caused.

If the overpayment cannot be recovered from the recipient, the trustees could in theory be liable to reimburse the scheme for the loss. However, it is unlikely that such a claim will be made unless the loss is substantial.

A statutory limitation period of six years applies to claims by trustees for recovery of overpayments from the member by way of repayment. However, no limitation period applies to claims for recovery from the member by way of deduction from future pension instalments, provided this is not disputed by the member.

3.4 Wrongful exercise of discretion

A claim might arise if (for example) the trustees failed to exercise a discretion properly when deciding how to pay a lump sum death benefit. This would be a combination of an underpayment claim (by the beneficiaries who have lost out) and an overpayment claim (because those beneficiaries would be alleging that the trustees had paid someone improperly).

3.5 Investment loss

A claim could theoretically be made in respect of losses caused by improper investment of the scheme's assets, or by a failure to supervise investment managers or custodians. As this would involve a loss to the scheme, such a claim could be a matter of personal liability for the trustees. However, where trustees have taken appropriate investment advice at regular intervals, it is very unlikely that such a claim would succeed.

3.6 Favouring the employer

If the trustees wrongly put the interests of the employer above those of the beneficiaries, for example, if they made a surplus refund without complying with the relevant provisions of legislation and the trust deed and rules, the trustees could be personally liable to make good the loss to the scheme.

3.7 Breach of statutory duties and penalties

As mentioned earlier, the Regulator can in principle fine trustees who breach their statutory duties. In practice, fines are generally imposed only in exceptional cases – the Regulator is more concerned about ensuring that mistakes are avoided in the future than about punishing trustees for mistakes that have occurred. The Regulator is also well aware that if it took too draconian an approach, people would simply not be prepared to act as trustees. Nonetheless, its power to fine trustees for breaches of a wide range of statutory duties is not one that trustees can ignore – it underlines the importance of taking those statutory duties seriously.

A further point to bear in mind is that trustees cannot be reimbursed out of the scheme's assets for any fine that the Regulator may impose, nor can they use the scheme's assets to insure against the risk of a fine.

4. Are trustee directors in a better position than individual trustees?

The directors of a corporate trustee are not themselves trustees. Therefore, they do not owe a direct fiduciary duty to pension scheme beneficiaries. The Courts will not allow the trustee directors to be sued as if they were individual trustees. However, they may still be liable in one of the two ways listed below. (Additionally, fines can be imposed by the Regulator on the directors of a trustee company if they have consented to or connived in a breach of legislation.)

4.1 Indirect liability

Trustee directors owe duties to the trustee company because of their position as directors. Those duties can be enforced by the company itself, or by subsequent trustees of the scheme who can in turn be sued by beneficiaries.

4.2 Accessory liability

Trustee directors may be liable if they have been accessories to a breach of trust. A trustee director will be an accessory if he or she knowingly assists in a dishonest and fraudulent design on the part of the trustee company, or if he or she dishonestly procures or assists in a breach of trust. “Dishonesty” here could include deliberately closing one’s eyes to something that appears to be wrong.

Thus, trustee directors can be liable in some situations, even though they are not trustees themselves. For that reason, it is safest to assume that trustee directors should comply with the duties that apply to individual trustees.

5. Exonerations, indemnities and insurance

As just explained, trustees (and to some extent directors of a trustee company) may in principle be personally liable where there is a breach of legal requirements, under the scheme’s trust deed and rules or otherwise. However, it is normal for them to be largely protected against that risk by a combination of exonerations, indemnities and insurance.

5.1 Exonerations

(a) Trust deed and rules

It is quite common for a scheme’s trust deed and rules to contain a clause saying that a trustee will not be personally liable for acts or omissions in the course of administering the scheme. The precise terms of such an exoneration clause should be checked in every case. Most exoneration clauses do not protect trustees from liability arising out of dishonesty or bad faith, and it is also doubtful how far a paid, professional trustee can be exempted from liability for negligence. Other exoneration clauses may provide no protection where the trustee is guilty of “wilful default” or took a decision that the trustee knew to be wrong at the time. If there is a corporate trustee, the clause needs to be checked to see whether it provides protection for trustee directors.

Legislation imposes some further limits on exoneration clauses. Under the Pensions Act 1995, liability for breach of a trustee's obligation "to take care or exercise skill in the performance of any investment functions" cannot be excluded or restricted by the scheme's trust deed and rules or any other document. This would override any exoneration provision in the scheme's trust deed and rules so that, for example, the trust deed could not exonerate trustees from personal liability if they were negligent in their selection of an investment manager.

(b) Exemption under the Trustee Act 2000

Under the Trustee Act 2000, a trustee is not liable for any act or default of an agent, nominee or custodian unless the trustee has failed to comply with the "duty of care" imposed by the Act, which is to exercise such care and skill as is reasonable in the circumstances. In the case of a pension scheme trustee, this protection does not apply to an agent, nominee or custodian appointed in the discharge of the trustee's "functions relating to investment", nor where the agent, nominee or custodian is a sponsoring employer or a person "connected with" such an employer.

(c) The Court's power to excuse

Even in the absence of an exoneration clause, the Trustee Act 1925 gives a Court power to relieve a trustee from personal liability if the trustee "has acted honestly and reasonably and ought fairly to be excused". The Courts have not given any guidance as to how they would apply this test, but they would probably ask whether (as a minimum) the trustee had acted as prudently as he or she would have done in relation to his or her own affairs. As to whether a trustee "ought fairly to be excused", much would depend on whether his or her actions had the sympathy of the Court.

5.2 Indemnities

(a) Indemnity from the scheme's assets

A trustee who, acting lawfully, commits a pension scheme to make payments to beneficiaries or to third parties, is entitled to insist that such expenditure should be met out of the scheme's assets. This is often referred to as "an indemnity out of the trust fund". The principle applies to trustee companies as well as to individual trustees and thus trustee directors can take advantage of it. It also applies to former trustees as well as to current trustees. However, many schemes' trust deeds and rules also give the trustees a right of indemnity out of the trust fund in any situation where the trustees have been acting in good faith, even if an inadvertent breach of the law has occurred. As with exoneration clauses, it is important to consider the exact terms of any indemnity clause. A further point to remember here is that a right of indemnity out of the trust fund will not help if the scheme's assets have been transferred out on a winding-up.

Legislation provides that no payment can be made from a scheme's assets for the purpose of reimbursing a trustee in respect of a fine imposed by a Court with criminal jurisdiction or a "civil penalty" imposed by the Regulator.

(b) Indemnity from the employer(s)

The trust deed and rules of a scheme may also (or alternatively) contain an indemnity from the principal employer or all the participating employers protecting the trustees against claims for breach of their duty to the beneficiaries. Again, it is always necessary to check the precise wording of such an indemnity clause to see what protection it gives to trustees.

The rule that trustees cannot be indemnified against the Regulator's fines out of scheme assets does not apply to indemnities from the employer. However, if the indemnity is in favour of the directors of a trustee company which is in the same group of companies as the company or companies giving the indemnity, further restrictions will apply. This is a complex area and a full explanation is beyond the scope of this Guide.

An indemnity from an employer is only as good as the employer that gives it. If the employer becomes insolvent, the indemnity will probably become worthless. For that reason, many schemes offer trustees both an indemnity from scheme assets and an indemnity from one or more of the employers.

5.3 Insurance

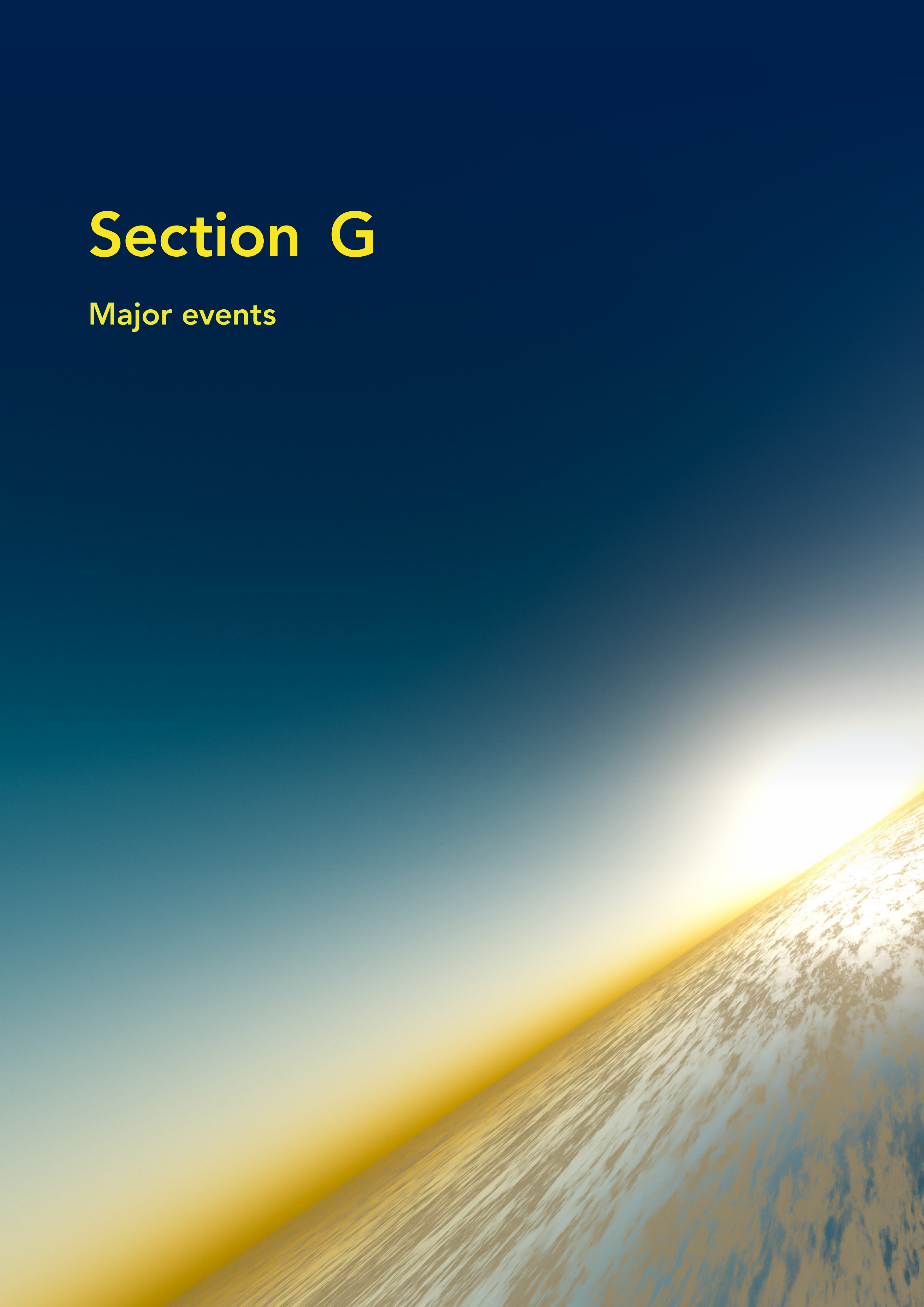
It is possible for a "trustee indemnity policy" to be taken out with an insurance company which will provide protection for trustees against claims for personal liability for breach of duty. It is also possible to obtain a policy which provides protection for the scheme against loss to it caused by negligence etc. by the trustees.

As with any insurance contract, the wording of the policy needs to be checked very carefully to see that it provides the protection that the trustees and the beneficiaries need. In particular, there is normally a cash limit on the insurance company's liability under the policy, and it is common to deny any liability where the trustees act dishonestly or in bad faith. It is not possible to pay an insurance premium out of the scheme's assets if the risks insured against include protecting trustees against liability for fines or civil penalties. If it is desired to have such protection, this can be achieved by having the premium divided into two parts – insurance against fines or penalties, and the rest of the premium. The employer pays the part of the premium relating to fines and penalties, and the rest of the premium can then be paid out of the scheme's assets.

Where trustees are to be protected both by an indemnity from the scheme or employers **and** trustee indemnity insurance, care should be taken that the insurance company cannot use the existence of the indemnity to reduce its liability under the policy. This can be achieved either by wording the indemnity in the trust deed so that it only applies where the trustees do not have an appropriate insurance policy, or by inserting wording into the policy so that the insurance company cannot use the existence of the indemnity to reduce its liability.

Section G

Major events



1. Amendments

1.1 Changes to the scheme in general

When contemplating any exercise of their powers, for example, the power to make changes to the benefit structure of the scheme, there are two main issues for the trustees to consider which can be expressed as follows:

- Can the trustees make the amendment? In other words, do the trustees have the power to make the proposed change under the scheme's trust deed and rules and under legislation?
- Should the trustees make the amendment? In other words, is it a proper exercise of the trustees' powers?

The trustees should only exercise their powers to make changes if they are satisfied that it is in the interests of the beneficiaries of the scheme. When deciding what is in the interests of beneficiaries, the trustees should consider all of their options, including the option of refusing to make the amendment(s), and also the implications which flow from choosing a particular option.

The trust deed of any well-drafted pension scheme will include a provision which says how the trust deed and rules can be amended. Typically, it will say that amendments can be made by the scheme's principal employer with the consent of the trustees (or vice versa), but it is not uncommon to see schemes where amendments can be made by the principal employer acting alone, or by the trustees acting alone.

The trust deed may require certain formalities to be followed – for example, there is often a requirement that any amendments must be made by a deed. Some schemes also require some form of consultation with members, or with the scheme actuary, before an amendment can take effect. If the amendment clause says that certain formalities must be followed, it is essential that they are, as the Courts will generally refuse to recognise amendments that were not made in the way the trust deed requires.

Many schemes also impose restrictions on what amendments can be made – for example, a provision saying that benefits already built up cannot be taken away. Again, the Courts take these restrictions very seriously, so it is important to check that any proposed amendment(s) would not breach the restrictions before it is made.

1.2 Changing benefits already earned – section 67 Pensions Act 1995

There are restrictions set out in section 67 Pensions Act 1995 on amending past service benefits under pension schemes. A code of practice about these restrictions has been published by the Pensions Regulator (and is available on its website). The effect of the restrictions depends on how past service benefits are to be changed. The legislation applies to two types of change – "protected modifications" and "detrimental modifications". If a modification is neither "protected" nor "detrimental", section 67 does not prevent it being made.

(a) Types of modification

A "protected modification" is one which would or might result in the replacement of defined benefits with DC benefits, or one which would involve reducing a pension in payment to less than its current rate.

A "detrimental modification" is one which would or might, in some circumstances, adversely affect the "subsisting rights" of a member. "Subsisting rights" are:

- A member's accrued rights to future benefits.
- A member's entitlement to pensions and other benefits which have already become due for payment.

Where a member is in pensionable service, their accrued rights are assessed as if they opted to end that pensionable service immediately before the modification is made, so – for active members – what section 67 really protects is the benefits they would have if they left pensionable service.

An amendment would or might be adverse if it would alter the nature or extent of a member's entitlement or right so that their benefits or future benefits would or might be less generous.

(b) The restrictions

A protected modification can only be made with the written consent of each affected member. There are detailed requirements for obtaining consent, including providing adequate information about the modification, and allowing time for the member to make representations.

A detrimental modification can only be made **either** with the written consent of each affected member **or** if the actuarial value of the affected member's subsisting rights immediately after the modification is equal to or greater than the actuarial value immediately beforehand and this is certified by the scheme actuary. Again, the member must be provided with adequate information about the modification and allowed time to make representations.

In addition, the following requirements apply to both protected and detrimental modifications:

- The trustees of the scheme must approve the modification, regardless of whether their approval is required by the scheme's trust deed and rules.
- The trustees must notify each affected member that they have approved the modification.

(c) Exempt modifications

There are a number of types of modification to which the section 67 requirements do not apply. These include modifications which would allow a member's subsisting rights to be transferred to another pension scheme, and modifications which ensure that benefits accrued after A-Day are not paid if this would be an unauthorised payment under the new tax regime introduced by the Finance Act 2004.

(d) Failure to comply

If a modification is made without complying with these requirements, the Regulator may make an order that the modification, or any rights granted under it, are void to the extent specified in the order.

A trustee or other person who exercises a power to modify a scheme in breach of these requirements may be liable to a fine from the Regulator.

1.3 Changing future service benefits – consultation

Employers normally have to consult with members before making significant changes to future service benefits under an occupational pension scheme. Trustees and employers will need to allow time for consultation when planning certain amendments which might be seen as detrimental to (some) members' interests.

The duty to consult does not apply to employers with fewer than 50 employees. Where it does apply, however, generally the consultation period must be at least 60 days.

Specifically, the changes requiring consultation are:

- Increasing normal pension age.
- Preventing new members from joining.
- Ending future benefit accrual.
- Ending employer contributions.
- Introducing or increasing member contributions.
- Reducing employer contributions to a DC scheme.
- Changing non-DC benefits to DC benefits.
- Changing the basis for determining the rate of future accrual in a DB scheme.
- Reducing the rate of future accrual in a DB scheme.
- Changing the measure of earnings used to calculate members' benefits.
- Changing the rate at which pensions in payment are increased and/or deferred pensions are revalued if the new rate would be less generous.

An employer must provide information about the proposed change to affected employees who are active or prospective members. Where there is a recognised trade union (or there is an information and consultation agreement under the Information and Consultation of Employees Regulations 2004) in respect of affected employees, the employer may consult in accordance with those arrangements. Otherwise the employer may consult elected representatives or directly with each affected member.

A complaint about a failure to comply with the consultation obligations may be made to the Regulator. The Regulator has various powers, including the power to issue an improvement notice requiring the employer to remedy its breach of the consultation obligation, and the power to levy a fine on the employer if it has no reasonable excuse for a failure to consult. (The amount of the fine is determined by the Regulator, subject to a maximum of £5,000 in the case of an individual and £50,000 in any other case.) However, a failure to consult will not affect the validity of the change.

The Regulator may also waive or relax any of the requirements in order to protect the interests of the generality of the members.

2. Closure to accrual

Over recent years, many employers have taken steps to close their DB schemes to future accrual.

2.1 What does closing a scheme to accrual involve?

Unless there is a power in the scheme's trust deed and rules allowing the employer to bring this about unilaterally, there are broadly four possible methods for ending benefit accrual. The first is through a rule amendment, which normally requires trustee agreement. The second is the contractual route, which requires the employer to seek members' agreement to a change to their employment contracts so that they are no longer entitled to accrue defined benefits in the scheme. The third is for the employer to offer members an incentive to opt out of the scheme. The fourth is to wind up the scheme (see paragraph 7 below).

2.2 The trustees' role in closing a scheme to accrual

If the employer takes the second or third approach, it will deal directly with its employees, and the trustees' role is quite limited. Once employment contracts have been changed, or all members have opted out, the employer will normally simply ask the trustees to make "housekeeping" amendments to the scheme's trust deed and rules to reflect what has happened.

If, on the other hand, the employer asks the trustees to agree to an amendment to the trust deed and rules, then the trustees will need to consider whether or not to agree. They will need to establish whether they can amend the trust deed and rules in the way requested by the employer and whether doing so would be a proper exercise of their amendment power. They will need to take advice from their legal adviser, the scheme actuary and perhaps other advisers – for example, they may need to take advice on the employer covenant.

2.3 Relevant trustee considerations

In order to establish whether they can make the amendment, the trustees must first consider the terms of the amendment power. Some amendment clauses are worded in such a way that they prohibit any amendment which stops past service benefits being linked to final salary. This would mean that, if closure is achieved through an amendment to the trust deed and rules, the salary link has to be preserved and members' benefits could not be calculated as if they had left service at the closure date.

Having established that they can make the amendment, the trustees need to consider whether they should do so. A key duty of trustees is to act in the interests of the scheme beneficiaries overall, and the trustees must be satisfied that their decision is in line with this duty. It is not obvious, on the face of it, why ending future accrual is in the interests of the active members. However, the duty is to act in the best interests of the beneficiaries overall, rather than each group of members or individual members so, although active members are losing their prospect of future accrual, there may be other factors to weigh in the balance.

In broad terms, the trustees should compare the likely outcomes in the long run if they agree and if they do not agree. Usually, the employer will ask the trustees to make the amendments as part of a package, which may involve accelerated funding of the scheme deficit and/or some form of security, which the trustees would not otherwise be able to negotiate as part of the normal funding negotiations. If it is clear that the employer would take steps to achieve closure by some other route if the trustees do not agree, then that is also something the trustees can take into account. The trustees may be able to negotiate a better outcome for members through a closure deal involving an amendment to the trust deed and rules

than if the employer were to take the contractual route to achieving closure, without involving the trustees. The trustees might also take into account the employer's financial situation – if the employer is having difficulty in funding the scheme, it may be better in the long run for members if accrual stops and all contributions go towards funding the past service deficit.

3. Mergers

Where an employer operates more than one occupational pension scheme, there is often a desire to merge the schemes as this may give rise to considerable administrative cost savings, as well as providing opportunities in relation to benefit harmonisation and broader investment options.

3.1 What does a scheme merger involve?

A scheme merger essentially involves a bulk transfer of assets and liabilities relating to members from one scheme to another, and this can be accomplished in a number of ways. The usual approach is to select one scheme which is to receive all the assets and liabilities from the other scheme (the "receiving scheme") and then, when the transfers are completed, the other scheme (the "transferring scheme") is wound up. Often, the assets and liabilities from the transferring scheme will be transferred into a legally separate section of the receiving scheme.

3.2 The trustees' role in a scheme merger

Trustees will only be able to agree to a scheme merger if their scheme's trust deed and rules contain a provision permitting a bulk transfer. If there is no express power to make a bulk transfer, the trustees will need to determine whether an amendment can be made in order to introduce a bulk transfer provision. Issues that trustees should consider in connection with this include the terms of the scheme's amendment power.

3.3 Relevant trustee considerations

As most scheme mergers cannot take place without trustee consent, it is essential that trustees understand their duties in assessing an employer's request to merge schemes. Broadly, trustees are under a duty to act in the best interests of all classes of beneficiaries. The trustees of the transferring scheme owe their fiduciary duties to the beneficiaries of the transferring scheme, and must ensure that full past service credit is available for their transferring members, reflecting the value of the bulk transfer payment. If active members are being transferred, the trustees will also be concerned about the benefit terms for future service in the merged scheme. The trustees of the receiving scheme owe their duties to the current beneficiaries of the receiving scheme, and they must be confident that sufficient assets will be transferred to the receiving scheme to meet the additional liabilities. To some extent, the employer may also be regarded as a beneficiary in both cases.

Trustees should consider all of the options available to them, including the option to reject merger proposals or to negotiate a more favourable package for the beneficiaries. The ability of the trustees to reject or negotiate a more favourable proposal will depend on who controls the key powers within the scheme.

The trustees of the transferring scheme should also consider the balance of powers under their scheme's trust deed and rules and compare it with the corresponding balance in the receiving scheme. If the receiving scheme's overall balance of powers is less favourable towards the beneficiaries than under the transferring scheme, then this is a point that the trustees of the transferring scheme should consider in deciding whether they can properly agree to the merger. An unfavourable shift in the balance of powers may be compensated for by other factors, for example if the receiving scheme is significantly better funded or provides more generous benefits. If this is not the case, however, then the trustees of the transferring scheme should consider asking for some benefit or safeguard for their members before agreeing to the merger.

The trustees of the transferring scheme may also, and in our view may properly, ask for some form of protection for themselves on a scheme merger. This seems especially appropriate if they currently have the protection of a right of indemnity from the transferring scheme's assets – that protection will become worthless if all the assets are transferred out of the transferring scheme.

These points are typically addressed in a transfer agreement between the trustees and the sponsoring employers of the transferring and receiving schemes.

4. Buy-ins and buy-outs

4.1 What is a buy-in?

A "buy-in" occurs when trustees buy an annuity policy in their names. The annuity policy becomes an asset of the scheme. The income stream from the policy will usually match benefits which the trustees have to pay to a certain class of members. However the policy does not require the income stream to be paid to those members exclusively. The policy's income is pooled with other scheme income and used to pay benefits as a whole. On a winding-up, the policy's capital value is an asset available to meet scheme liabilities as a whole.

By effecting a buy-in, the trustees acquire an asset which matches (or closely matches) the liabilities referable to a particular class of members. This reduces volatility in the scheme.

4.2 What is a buy-out?

A "buy-out" occurs when trustees buy an annuity policy in the name of someone entitled to benefits under their scheme. A buy-out establishes a direct contractual relationship between the insurer and the person in whose name the policy is bought. The person ceases to be entitled to benefits under the pension scheme, and the insurer becomes responsible to that person for paying the benefits under the policy. The benefits provided by the policy must exactly match the benefits which the scheme would otherwise have provided.

Buy-outs generally occur when a scheme is wound up. However, some schemes buy out certain members or groups of members whilst the scheme is ongoing.

A buy-out removes the liabilities associated with the beneficiaries whose benefits are bought out. These cease to be liabilities of the scheme.

4.3 Issues to consider

(a) Legal power to buy in or buy out

If buying in, the scheme's investment power must be wide enough to allow the trustees to buy the annuity policy.

If buying out, trustees should check their trust deed and rules to ensure that they have the power to buy out. (Trustees may be able to amend their trust deed and rules if this power is not present.)

(b) Investment advice

If trustees buy in, the policy will be a scheme asset. Trustees will therefore need to comply with the law regarding scheme investments and obtaining investment advice.

(c) Security of benefits

A buy-out may adversely affect remaining members' security of benefits. The Courts have held that where a scheme is entering the Pension Protection Fund (PPF), trustees cannot use a buy-out power to buy out benefits in excess of those that the PPF will provide. If PPF entry is likely, trustees should be cautious about buy-outs.

(d) Matching benefits

Trustees should check that the benefits provided by a buy-out policy exactly match the benefits being bought out. This can be complicated and lengthy. If benefits contain GMPs, the scheme's records will need to have to been reconciled with HMRC's records.

The benefits provided by a buy-in policy should also match the benefits covered by the policy, but because the scheme remains ultimately liable to provide the benefits to the members, mismatches between the benefits provided by the policy and those payable under the scheme's trust deed and rules will not result in members not receiving the benefits to which they are entitled.

(e) Robustness of insurer

Trustees should investigate the insurer's robustness (especially if buying out). Trustees should take advice on the insurer's financial stability, track record, processes, and customer relations.

(f) Secured buy-ins

Some insurers will sell policies that allow trustees to recover part of the premium if the insurer defaults. These complicated, bespoke arrangements may be suitable for large buy-ins.

(g) Financial Services Compensation Scheme

The Financial Services Compensation Scheme is available if an insurer fails. It is funded by a levy on financial institutions, so is itself vulnerable to market conditions. It pays compensation equal to 100% of a policy's value.

5. Employer debts on insolvency, winding-up or employer departure

Section 75 Pensions Act 1995 says that an employer must make good its share of any deficit in a DB scheme if certain trigger events occur. An employer's liability under section 75 is often referred to as a "section 75 debt".

The trigger events are as follows:

- Insolvency of the employer.
- An employment-cessation event (ECE) in relation to the employer.
- Winding-up of the scheme.

An ECE occurs if an employer in a multi-employer scheme ceases to employ active members at a time when at least one other employer continues to employ active members. However, the legislation provides for a period of grace (12 months, potentially extendable to 36 months), so that an employer need not immediately suffer a section 75 debt if it ceases to employ active members, but expects to do so again in the near future. The legislation also includes two easements whereby an ECE may be averted on a restructuring.

In addition, an employer who suffers an ECE can defer payment of the section 75 debt thereby triggered by entering into a deferral arrangement. A number of conditions must be met, including a requirement for written trustee consent. The deferred employer will continue to be a scheme employer for funding purposes. The deferral arrangement will come to an end upon the occurrence of certain prescribed events.

An ECE can also be triggered voluntarily by an employer in a frozen scheme (i.e. a scheme which has no active members).

5.1 Valuing liabilities for the purposes of section 75

For the purposes of section 75, a scheme's liabilities are valued on a buy-out basis (which reflects the cost of securing benefits by buying annuities). Most schemes have a substantial deficit on a buy-out basis. This is one reason in practice why employers who want to stop accrual in a DB scheme do not usually do it by triggering a winding-up.

The legislation specifies a default mechanism for calculating an employer's share of the deficit in a multi-employer scheme. The calculation involves comparing the liabilities relating to the employer with the liabilities relating to all current employers.

The legislation allows certain arrangements to be put in place to change an employer's section 75 debt in a multi-employer scheme, provided that prescribed conditions are met. These arrangements are always subject to the approval of the trustees. The main ones are listed below:

- *Apportionment arrangement*

  This is an arrangement which changes the share of the deficit for which an employer is responsible, so that the default calculation mechanism does not apply. The arrangement will apportion liabilities, for section 75 purposes, from one employer (A) to another (B). Under a "scheme apportionment arrangement", an amount of A's liabilities is apportioned to B. Under a "flexible apportionment arrangement", the whole of A's liabilities are apportioned to B, so that B steps into the shoes of A as far as section 75 is concerned.

- *Withdrawal arrangement*

  This is an arrangement which reduces the debt that an employer has to pay on withdrawal. In return for the reduction, a guarantor (either the withdrawing employer or another company) must give the trustees a long-term guarantee.

A section 75 debt is payable immediately, unless the trustees agree to allow time for payment or a deferral arrangement is entered into. But trustees need to be careful in negotiating with employers about section 75 debts, so as to avoid prejudicing the scheme's PPF protection (see Section H paragraph 2.1).

5.2 Employer insolvency and the Pension Protection Fund

The insolvency of a sponsoring employer in a DB scheme will usually trigger what is known as a PPF "assessment period" in respect of the scheme (or, if applicable, the employer's section of the scheme). During an assessment period, the PPF will assess whether the level of funding in the scheme (or section) qualifies the scheme (or section) for entry to the PPF. Should the scheme (or section) be accepted into the PPF, the PPF will take over responsibility for the scheme (or section) from the trustees, and will pay compensation to the members equivalent to the benefits they would have received, subject to a statutory cap. See Section H paragraph 2 for more information on the PPF.

6. Transactions

When a company or business is sold, the pension obligations lie primarily with the employer or their parent company. Trustees should be aware of the basic structure of the transaction.

6.1 Share sale

Where the transaction is the sale of a company, the employment contracts do not change. However, future benefits are likely to have to be provided under the buyer's scheme.

Where the company participates in the seller's DB scheme, this may result in the company withdrawing from that scheme which could trigger a section 75 debt (see paragraph 5 above).

6.2 Business sale

Where the transaction is the sale of a business, employment legislation known as TUPE says that the employment contracts of the employees working in that business will normally transfer to the buyer automatically. Although that legislation does not apply to the part of employment contracts relating to occupational pension schemes (subject to some exceptions relating to enhanced early retirement rights), the buyer will have to comply with the Pensions Act 2004. In essence, this requires that, where the transferring employees were members of the seller's occupational pension scheme, the buyer must provide replacement pension provision.

Where the buyer provides a DB scheme:

- the members must be entitled to benefits whose value is equal to or exceeds 6% of pensionable pay for each year of employment (if members are required to make contributions, their contribution rate must not exceed 6% of pensionable pay); or
- the employer must match the transferring employees' contributions up to 6% of pensionable pay.

Where the buyer provides a DC scheme, the employer must:

- match the transferring employees' contributions up to 6% of pensionable pay; or
- match the transferring employer's contributions, where the transferring employer was under an obligation to make those contributions, provided the contributions were solely for the purposes of producing DC benefits.

6.3 Transfer payments

The seller may agree to transfer the past service pension rights accrued in its scheme for the employees of the sold employer, plus assets to cover them, to the buyer's pension scheme. The terms of the transfer would be set out in a "pension schedule" to the sale and purchase agreement, together with an "actuary's letter" containing the financial assumptions for the calculation to be made later. The trustees are not of course bound by the sale and purchase agreement, and should calculate any transfer payment in accordance with the scheme's trust deed and rules.

6.4 Declaration of intent

In February 2019, the government announced that it would introduce a requirement for a party planning any of the following corporate transactions in respect of a sponsoring employer to issue a "declaration of intent" to the scheme's trustees and the Regulator:

- Sale of a controlling interest in a sponsoring employer.
- Sale of a material proportion of the business or assets of a sponsoring employer which has funding responsibility for at least 20% of the scheme's liabilities.
- Granting of security on a debt to give that debt priority over debt to the scheme.

The declaration of intent must include an explanation of the transaction, confirmation that the trustees have been consulted, and an explanation of how any detriment to the scheme is to be mitigated.

7. Winding-up

Most schemes' trust deed and rules include a provision which specifies certain events that will trigger a winding-up of the scheme – these typically include a power for the scheme's principal employer to trigger a winding-up. Some schemes give trustees a similar power.

As mentioned earlier, the winding-up of a DB scheme will normally lead to a debt falling due from the employer under section 75 Pensions Act 1995, of an amount which – if the employer can pay it – would allow all of the scheme's liabilities to be bought out. If the employer is unable to pay that amount, and in fact the scheme could not even buy out the benefits which the PPF would provide (see Section H paragraph 2.5), then the scheme will be taken over by the PPF.

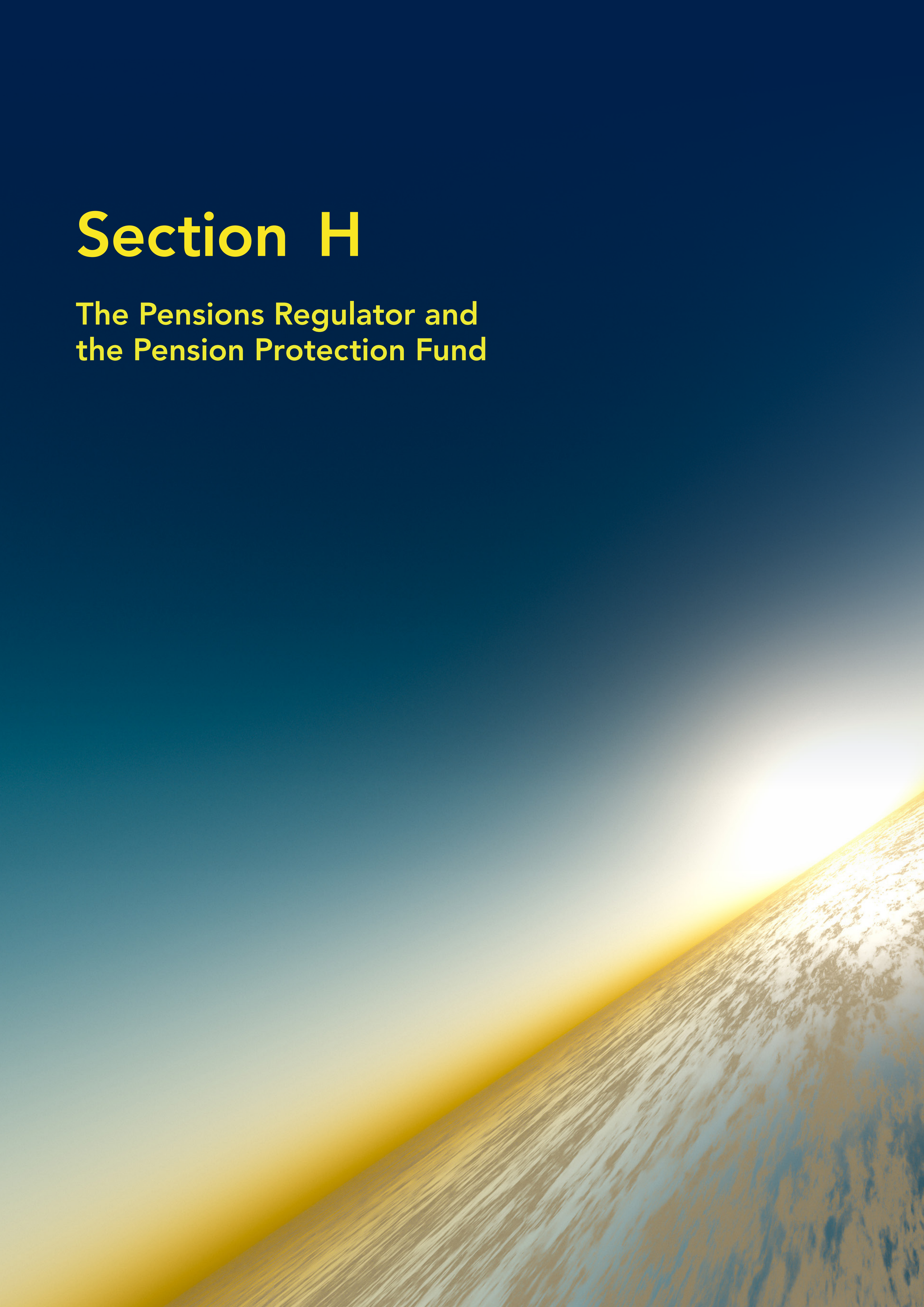
However, for schemes that are too well-funded to fall into the PPF, but which cannot afford to buy out their benefits in full, section 73 Pensions Act 1995 sets out the order in which scheme liabilities must be met when a pension scheme winds up. For schemes which started winding up after 5 April 2005, the winding-up priority is as follows:

1. Liability for benefits already secured for individual members by insurance policies taken out before 6 April 1997 where the policy cannot be surrendered by the trustees.
2. Liability for pensions or other benefits to the extent they would have been met by the PPF.
3. Liability for other benefits which, in the opinion of the trustees, are derived from the payment of AVCs.
4. Any other benefit liabilities.

Where the scheme assets are insufficient to meet all of the members' benefits in any category, then the benefits within that category will be reduced proportionately.

Money purchase benefits are excluded from the definition of liabilities for this purpose in relation to schemes which started winding up after 5 April 2005.

A scheme's trust deed and rules will normally include a provision specifying the order in which liabilities are to be met on winding-up. But section 73 will override any such provision in practice, except as regards DC benefits.



Section H

The Pensions Regulator and the Pension Protection Fund

1. The Pensions Regulator

1.1 Duties of the Pensions Regulator

The Pensions Regulator was established under the Pensions Act 2004. It replaced a previous regulatory body called the Occupational Pensions Regulatory Authority or OPRA. The Regulator's statutory objectives are to:

- Protect the benefits of members of occupational pension schemes and workplace personal pension schemes.
- Promote good administration of workplace pension schemes.
- Reduce the risk of situations arising that may lead to claims on the PPF.
- In relation to the exercise of its scheme funding functions, minimise any adverse impact on an employer's sustainable growth.
- Maximise compliance with the automatic enrolment duties (which largely apply to employers).

1.2 Powers of the Pensions Regulator

Pensions legislation gives the Regulator a wide range of powers to achieve its aims. Among other things, it can issue codes of practices and guidance. Although the codes of practice are not law, the Courts and the Pensions Ombudsman will take them into account in deciding whether a legal requirement has been met. However, the Regulator's guidance has no special legal status.

The Regulator also has powers in relation to employers and trustees. Its main powers in relation to employers include its anti-avoidance or "moral hazard" powers described in paragraph 1.2(j) below. Whilst trustees have no direct role to play under the moral hazard legislation, they should view themselves as an unsecured creditor of the employer and, if they believe that an employer is seeking to avoid a section 75 debt, they may wish to raise the matter with the Regulator.

The Regulator has important powers in relation to pension scheme trustees. Probably the ones which most directly concern trustees are the Regulator's power to fine trustees (or directors of a trustee company) if they fail to comply with duties under pensions legislation, and also its ability to intervene in scheme funding matters.

(a) Fines

The Regulator can fine trustees if they breach their duties under pensions legislation (or, in the case of the directors of a corporate trustee, if they have "consented to or connived in" a breach of duty). In theory, the maximum fine for a single breach that the Regulator can impose is £5,000 (for an individual) and £50,000 (for a company). The maximum penalties for some breaches are lower. Trustees cannot use scheme assets to pay these fines, or to pay for insurance cover against them.

In practice, the Regulator generally prefers at present to encourage compliance (often without resorting to its range of formal powers) rather than to punish non-compliance. As a result, the issuing of an improvement notice (see paragraph 1.2(g) below) is a more likely first step, other than in extreme cases.

(b) Scheme funding

As we explain in Section E paragraph 3.3, in some circumstances the Regulator can intervene in scheme funding matters, especially where the trustees and employers cannot agree on what contributions an employer should be paying to the scheme.

(c) Gathering information

The Regulator can require anyone holding relevant documentation or information to produce it at any time and can inspect premises, to investigate whether pensions legislation is being complied with.

Not providing (without reasonable excuse) the information requested by the Regulator as part of an inspection is a criminal offence. Knowingly or recklessly providing the Regulator with information that is false or misleading could result in a fine or even imprisonment for up to two years.

(d) Freezing orders

The Regulator can make freezing orders in respect of DB schemes where the winding-up of the scheme is pending. Freezing orders temporarily halt all activity within the scheme so that the Regulator can investigate its concerns. They can only be made if the Regulator thinks there may be a risk to members' interests or scheme assets and that the freezing order is necessary to protect the interests of the "generality of" members.

(e) Winding up schemes

The Regulator has a general power to wind up an occupational pension scheme.

(f) Appointing/suspending/removing trustees and prohibition orders

The Regulator can appoint trustees, suspend them from office, and prohibit people from acting as trustees of a scheme. The Regulator keeps a register of prohibited trustees which is available on its website.

It also has power to appoint new trustees to a scheme to ensure that the trustee body is equipped to carry out its role properly, or if the Regulator is satisfied that it is otherwise reasonable to do so in order to protect the interests of the generality of members of the scheme. The Regulator has a separate power to appoint an independent trustee to a scheme where a sponsoring employer has become insolvent.

(g) Improvement notices/third party notices

The Regulator also has power to issue "improvement notices", which require individuals or companies to take (or to refrain from taking) steps within a certain period in order to remedy a breach of pensions legislation or to stop a breach happening again.

Notices may also be sent to third parties, where the breach results from their failure to do something and that failure is not of itself a breach of pensions legislation.

(h) Unpaid contributions

Where an employer does not pay its contributions on time, the Regulator may exercise whatever powers the trustees have to recover them on the scheme's behalf.

(i) Injunctions and Court orders

The Regulator can apply to the High Court for an injunction where it considers that it is reasonably likely that someone will misuse or misappropriate pension scheme assets. The Regulator can also ask the High Court to order a person to restore the parties to their previous position if the Court believes that the person was knowingly concerned in misuse or misappropriation of scheme assets.

(j) Anti-avoidance or "moral hazard" powers

The Regulator also has some extremely important powers in relation to employers. We will describe them only briefly here, as it is employers rather than trustees who are directly affected by them. However, trustees should be aware of them, if only because those powers will inform the employer's thinking.

- *Contribution notices*

The Regulator can issue a contribution notice (CN) against a person who has been a party to (i) avoidance of a section 75 debt (see Section G paragraph 5), or (ii) an act (or failure to act) which has a materially detrimental effect on the likelihood of members receiving their benefits under a DB scheme. Where the Regulator proposes to issue a CN in relation to an act falling within limb (ii), the proposed recipient will have a statutory defence (meaning the CN cannot be issued) if it can satisfy the Regulator that:

- It considered the extent to which the act or failure might have a materially detrimental effect on the likelihood of members receiving their benefits.
- If it considered that there might be such an effect, it took all reasonable steps to eliminate or minimise the potential detrimental effect.
- If it considered that there would not be such an effect, it was reasonable for it to have reached that conclusion.

A CN will require the person to pay a contribution to the scheme, which may be of any amount up to the scheme's deficit on a section 75 basis. A CN can be served on an employer of a DB scheme, another company in the same group, or on various other parties who are connected or associated with the employer.

Almost any event which weakens a company financially or detrimentally affects the security of the scheme could potentially give rise to a CN. However, the Regulator has published guidance that provides an indication of what is likely to be considered material.

- *Financial support directions*

The Regulator can also issue a financial support direction (FSD) to a person in some circumstances. The notice will require the person to put in place financial support for the relevant DB scheme, for example a guarantee of its obligations. This power applies regardless of whether there has been any avoidance of a section 75 debt.

The Regulator can issue a FSD to a person only if the employer is a service company (i.e. one whose turnover derives wholly or mainly from providing the services of its employees to other companies in the same group) or is "insufficiently resourced", and the person is the employer or a company connected or associated with the employer.

An employer is "insufficiently resourced" if:

- The value of the employer's resources is less than 50% of the estimated section 75 debt.
- Connected or associated companies have combined resources with a value which is at least equal to the shortfall.

- *Clearance statements*

CNs and FSDs are effectively the nuclear weapons in the Regulator's arsenal, and legislation ensures that they can only be used when it is reasonable to do so. However, the mere existence of these powers, and the uncertainty about when the Regulator might decide it is reasonable to use them, means that they are of genuine concern to employers who are therefore likely to think more carefully before taking steps that might otherwise adversely affect benefit security. A further result is that trustees may find employers asking them to join in an application to the Regulator, asking it to provide a "clearance" statement to the effect that it will not exercise these powers if the employer takes a particular step.

- *Restoration orders*

Where there has been a transaction at an undervalue using scheme assets, the Regulator may take action aimed at restoring what the position would have been had the transaction not taken place.

(k) Automatic enrolment compliance notices

Where an employer has contravened a duty under the automatic enrolment regime, the Regulator can issue a notice requiring the employer (or, where the employer's contravention is due to a failure on the part of a third party, requiring that third party) to take (or refrain from taking) specified steps in order to remedy the contravention.

The government announced in February 2019 that as part of a package of measures to better protect DB pension schemes:

- The Regulator will be given a range of new powers, including an ability to issue fines of up to £1 million for breaches of certain statutory duties.
- Changes will be made to the Regulator's anti-avoidance powers.

It is not currently clear when these powers will be introduced.

1.3 Cross-border activity

The Regulator also has a role in relation to schemes which operate cross-border and have members in the UK and in another state in the European Economic Area (EEA). A scheme must apply to the Regulator for authorisation to operate as a cross-border scheme. This requirement affects any UK occupational pension scheme accepting employer contributions for employees:

- Whose place of work is in another state in the EEA (the EU plus Iceland, Liechtenstein and Norway).
- Whose relationship with their employer is subject to the social and labour law relevant to occupational pension schemes in that other EEA state.

Guidance issued by the Regulator explains how to apply for authorisation and approval. It can be found on the Regulator's website.

The legal requirements that apply to cross-border schemes – in particular as regards DB funding – are more onerous than those which apply to purely "domestic" schemes. For that reason, employers may be keen to ensure that their scheme does not become a cross-border scheme.

The cross-border regime will be repealed from the date of Brexit.

2. The Pension Protection Fund

Since 6 April 2005, the Pension Protection Fund (PPF) has been available to provide some protection for members of DB pension schemes where the sponsoring employer becomes insolvent on or after 6 April 2005 and the scheme had not started to wind up before that date. (A different scheme – the Financial Assistance Scheme – may be able to give limited help to members of schemes that began to wind up with an insolvent employer between 1 January 1997 and 5 April 2005.) The legislation sets out which schemes are covered by PPF protection, what benefits are protected, how a scheme is assessed to see whether it qualifies for PPF protection, how that protection is provided, and how the PPF is funded.

2.1 Which schemes are covered?

Most DB schemes are potentially eligible to enter the PPF. However, some categories of scheme are excluded, for example, those with a Crown guarantee, those with fewer than 12 members all of whom are trustees, schemes that are not registered pension schemes, and schemes that do not have their main place of administration in the UK. The PPF has power to refuse to provide PPF protection to schemes that are set up deliberately to take advantage of the provisions of the PPF, for example, a group scheme hiving off an employer and its employees to a separate underfunded scheme after which the employer was allowed to become insolvent.

PPF protection can also be denied to a scheme whose trustees have compromised the amount of a section 75 debt payable by an employer (see Section G paragraph 5) (except where the PPF or the High Court has sanctioned the compromise). Trustees therefore need to be careful in agreeing any compromise with an employer because they might thereby be denying the members of the scheme future protection from the PPF. However, changes to the legislation relating to employer debts and PPF entry, introduced from 6 April 2008, provided that trustees can enter into withdrawal arrangements and apportionment arrangements (see Section G paragraph 5) without those arrangements being regarded as compromises for this purpose. Similarly, entry into a deferral arrangement which meets the conditions prescribed in legislation (see Section G paragraph 5) will not prejudice the scheme's PPF protection.

DC schemes are not eligible to enter the PPF.

2.2 Insolvent employer

The government wants PPF protection to be available for a scheme only where the sponsoring employer is insolvent. Solvent employers are expected to make good any deficits which arise in their DB schemes. Where the employer is a company, the scheme only qualifies for the PPF if the company has an "insolvency event" on or after 6 April 2005. The term "insolvency event" covers most forms of administration, liquidation or receivership, other than a members' voluntary liquidation. There are similar definitions for other types of employer, for example, partnerships, individuals etc. In the case of charities and certain statutory bodies which cannot legally be made insolvent, there is a procedure under which the trustees of the scheme can seek PPF protection if they become aware that the employer "is unlikely to continue as a going concern".

Multi-employer schemes are categorised by the PPF as either "segregated" or "non-segregated". A segregated scheme is one which is divided into two or more sections and contributions payable by an employer or a member are allocated to that employer's or member's section, and a specified proportion of the assets of the scheme is attributable to each section and cannot be used for the purposes of any other section. A scheme which is not already segregated in this way may have a "segregated part" created on the withdrawal or insolvency of one employer if the trust deed and rules allow or require the trustees to do that.

If a scheme is segregated, or if a segregated part is created on withdrawal or insolvency, the PPF legislation will be applied to each section as if it were a separate scheme. A non-segregated scheme is only eligible for PPF protection if all the sponsoring employers have had "insolvency events".

2.3 What benefits does the PPF protect?

Below is a list of the benefits that will be protected by the PPF (known as "protected liabilities") if the scheme becomes eligible for PPF protection. The question as to which category a particular benefit falls into will be decided as at the "assessment date" which will normally be the date of the relevant insolvency event. Benefit improvements that took effect in the three years before the assessment date will normally be disregarded in deciding what benefits are eligible for PPF protection.

The following benefits are eligible for 100% protection:

- Members' pensions in payment at the assessment date where the member has attained normal retirement age under the scheme or took ill-health early retirement.
- Survivors' pensions in payment at the assessment date.

People in the above categories may however lose out when entering the PPF because of the restrictions on pension increases and death benefits (see below). All other members' pensions are only eligible for 90% protection and furthermore are subject to a cap. The cap for 2019/20 is £36,018.31 (90% of a headline figure of £40,020.34). Where a member has more than 20 years' pensionable service, the cap is increased by 3% for each additional year of service, up to a maximum of double the standard cap. In the case of a current pensioner who has not reached normal retirement age at the assessment date and is not an ill-health early retirement pensioner, the cap is reduced by an early retirement factor and further reduced to take account of any commutation lump sum that the member took at retirement.

Where the member dies after the assessment date, the PPF will protect any widow's or widower's or civil partner's pension payable on the member's death by paying a pension of 50% of the member's pension (reduced, where appropriate, by the 90% restriction and the cap). In certain circumstances, cohabiting partners and surviving children are eligible for payments from the PPF.

The PPF protects future increases on pensions in payment, but only on the part of the pension attributable to service after 5 April 1997, and only up to a maximum of the increase in the Consumer Prices Index (capped at 2.5% per annum).

In September 2018, the Court of Justice of the EU held that EU legislation requires member states to ensure that, where an employer enters insolvency, each member of its occupational pension scheme(s) receives at least 50% of their benefits under the scheme. The decision means that the PPF compensation regime does not fully comply with the Insolvency Directive as some members with particularly large pensions may receive less than 50% of their benefits as a result of the PPF compensation cap and the restrictions that the PPF applies to pension increases. Changes will therefore need to be made to the PPF compensation regime, but exactly what these changes will be have not yet been confirmed.

2.4 Assessment

Where an employer with an eligible scheme has an insolvency event, the insolvency practitioner must notify the PPF unless he or she considers that the scheme will not need PPF protection because the scheme has been rescued (in other words, the scheme could continue notwithstanding the insolvency of the employer, for example, on a corporate restructuring where another solvent company is prepared to take over as the principal employer).

The PPF then makes an assessment of the scheme to establish whether the scheme would be able to meet its protected liabilities. The assessment will involve an actuarial valuation of the scheme on a basis set out in the legislation, and also a complete data cleansing exercise to establish the precise liabilities of the scheme. The assessment period cannot be less than 12 months and, in practice, it could be much longer.

During the assessment period, the trustees continue to be responsible for the scheme's administration, but subject to restrictions imposed by legislation, including requirements that certain trustee actions are subject to the consent of the PPF. Because of these restrictions, there is no longer a requirement for the insolvency practitioner to see that the scheme has at least one independent trustee, but the Regulator can appoint an independent trustee if it considers this appropriate.

2.5 Transfer of scheme into the PPF

If the assessment by the PPF reveals that the scheme does not have enough assets to meet its protected liabilities and none of the exceptions in the legislation apply, the insolvency practitioner will issue a scheme failure notice.

The PPF will then issue a transfer notice. The effect is that the assets and liabilities of the scheme will transfer to the PPF, and the PPF will become liable to pay compensation to members. The PPF is then responsible for the future administration of those benefits, and the trustees of the scheme will be discharged from any further liability in respect of the scheme. Beneficiaries will cease to have any claim to the benefits of the scheme, but will be able to claim their protected benefits in the form of compensation from the PPF.

The exceptions where the PPF will not issue a transfer notice are where:

- the scheme is not eligible for PPF protection;
- there will be a "scheme rescue" (see paragraph 2.4 above); or
- the scheme has sufficient assets to meet its protected liabilities.

In the second case, the scheme simply continues until such time as it is either wound up or another PPF assessment period is triggered. In the first and third cases, the legislation provides for the PPF to cease regulating the scheme and for the trustees of the scheme to wind it up, if possible. If winding-up is not possible, the scheme can be continued as a closed scheme with no further contributions or benefit accrual, but with the trustees still being required to meet benefits as and when they fall due. The trustees of a scheme which had sufficient assets to meet its protected liabilities can go on to claim PPF protection if, at a future date, it becomes clear that the scheme no longer has the assets to meet its protected liabilities.

2.6 PPF levies

The PPF is funded by levies imposed on eligible schemes. The PPF levy is made up of two elements – a scheme-based levy (which is based on the number of scheme members and the level of the scheme's liabilities) and a risk-based levy (which is based on the risk posed by the scheme to the PPF). The PPF's levy estimate for the 2019/20 levy year is £500 million (down from £550 million for the 2018/19 levy year). Schemes can reduce the risk-based element of the levy by certifying a contingent asset (such as a parent or group company guarantee, charge over cash, UK real estate or securities, or a letter of credit or bank guarantee) with the PPF. In order to be capable of certification, the contingent asset must meet strict requirements imposed by the PPF. Contingent assets must be re-certified annually.

There is also a PPF administration levy which is calculated according to the number of members in the scheme.

Notifiable events to be reported by trustees

Description of notifiable event	Conditions (defined below)
Events which must always be notified	
Decision by the trustees to grant benefits on more favourable terms than provided for under the scheme rules, without having: (a) sought the advice of the actuary; or (b) obtained any further funding recommended by the actuary.	N/A
Decision by the trustees to enter into a flexible apportionment arrangement.	N/A
Events which must only be notified if the specified conditions are not met	
Decision by the trustees to take action which will, or is intended to, result in a debt to the scheme not being paid in full.	A + B + C
Decision by the trustees to make/accept a transfer payment whose value exceeds the lower of: (a) 5% of the value of the scheme's assets; and (b) £1.5 million.	A + B
Decision by the trustees to grant benefits to a single member, the cost of which exceeds the lower of: (a) 5% of the value of the scheme's assets; and (b) £1.5 million.	A + B
Decision by the trustees to enter into a scheme apportionment arrangement.	D

NB – Two or more changes in holders of key scheme posts in 12 months is no longer a notifiable event.

Conditions:

A The scheme was fully funded on the PPF basis at its most recent valuation.

B The trustees have not needed to report any non-payment under the schedule of contributions to the Pensions Regulator in the previous 12 months.

C The debt not collected is less than 0.5% of the scheme's assets as at the scheme's most recent valuation.

D The scheme apportionment arrangement was entered into on or after the date on which the apportioned debt was triggered.

Notifiable events to be reported by employers

Description of notifiable event	Conditions (defined below)
Events which must always be notified	
Decision by an employer to take action which will, or is intended to, result in a debt to the scheme not being paid in full.	N/A
Decision by an employer to cease to carry on business in the UK.	N/A
Receipt by an employer of advice that it is trading wrongfully or circumstances being reached in which a director or former director of an employer knows that there is no possibility of that employer avoiding going into insolvent liquidation.	N/A
Conviction of a director or partner of an employer for an offence involving dishonesty.	N/A
Events which must only be notified if the specified conditions are not met	
Breach by an employer of a covenant in an agreement with a bank or institution providing banking services unless the bank or other institution has agreed not to enforce the covenant.	A + B
Decision by a controlling company to relinquish control of an employer.	A + B

NB – A change in an employer's credit rating (including an employer ceasing to have a credit rating) and two or more changes in key employer posts in 12 months are no longer notifiable events.

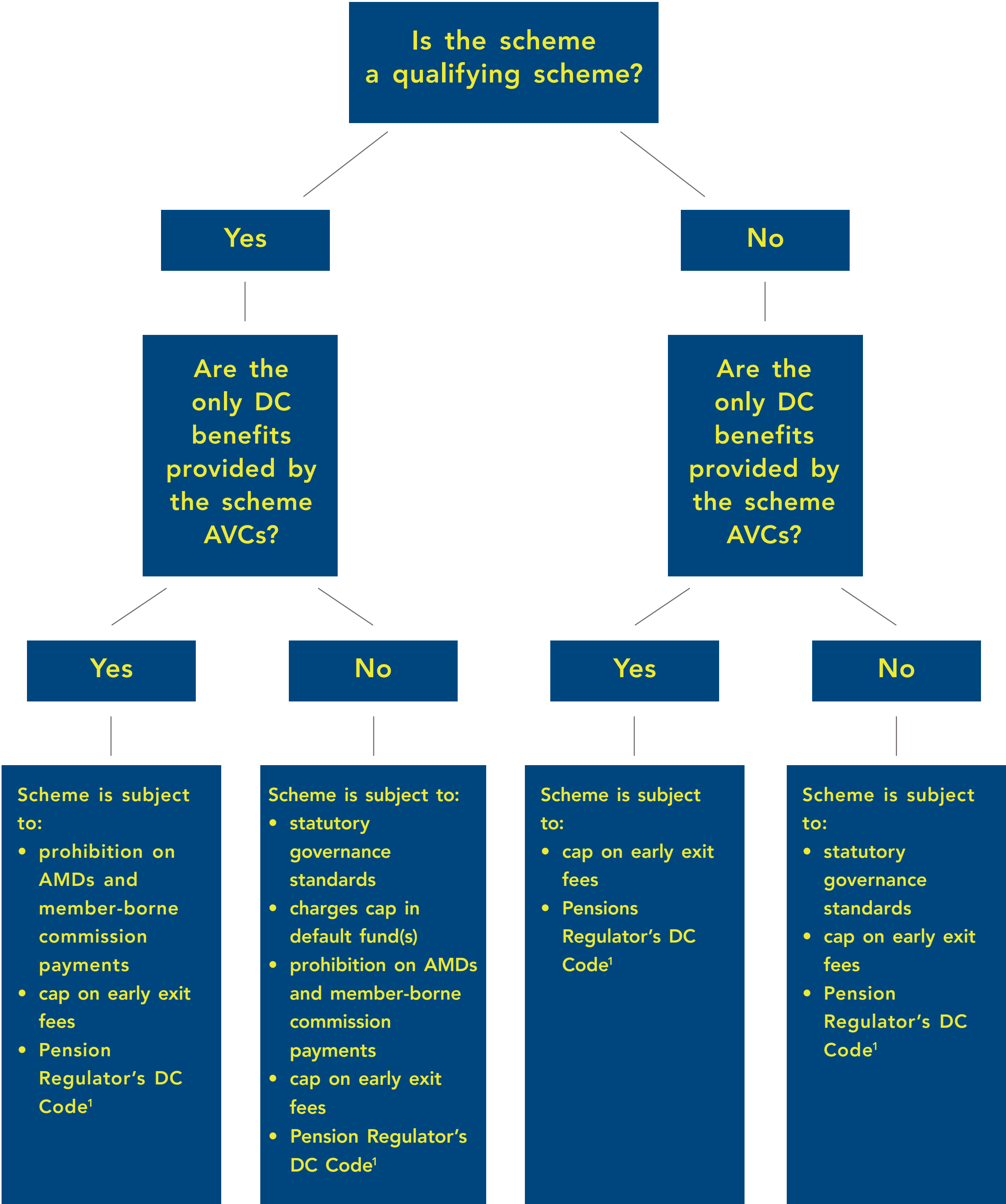
NB – The government announced in February 2019 that changes would be made to the list of employer-related notifiable events. It is not currently clear when these changes will be made.

Conditions:

A The scheme was fully funded on the PPF basis at its most recent valuation.

B The trustees have not needed to report any non-payment under the schedule of contributions to the Pensions Regulator in the previous 12 months.

DC Governance Flowchart



[1] The Pensions Regulator's code of practice for DC schemes dœs not have statutory force. However, the Courts and the Pensions Ombudsman are required to take account of the code's provisions when considering whether trustees have fulfilled their legal duties.

Glossary

Below are the abbreviations used in this Guide, as well as some other abbreviations that are frequently used in the pensions industry.

AA	annual allowance
A-Day	6 April 2006
AMD	active member discount
AVCs	additional voluntary contributions
BCE	benefit crystallisation event
CARE	career-average revalued earnings
CEP	contributions equivalent premium
CETV	cash equivalent transfer value
CGT	capital gains tax
CN	contribution notice
CPI	the Consumer Prices Index
DB	defined benefit
DC	defined contribution
DWP	the Department for Work and Pensions
ECE	employment-cessation event
ECJ	the Court of Justice of the European Union
EEA	the European Economic Area
EPBs	equivalent pension benefits
ERI	employer-related investment
ESG factors	environmental, social and governance factors
ETV	enhanced transfer value
FA 2004	the Finance Act 2004
FAS	the Financial Assistance Scheme
FCA	the Financial Conduct Authority
FSCS	the Financial Services Compensation Scheme
FSD	financial support direction
FSMA	the Financial Services and Markets Act 2000
GAD	the Government Actuary's Department
GDPR	the EU General Data Protection Regulation
GMP	guaranteed minimum pension

HMRC	HM Revenue & Customs
HMT	HM Treasury
IDRP	internal dispute resolution procedure
IFA	independent financial adviser
IHT	inheritance tax
IMA	investment management agreement
ITEPA	the Income Tax (Earnings and Pensions) Act 2003
LDI	liability-driven investment
LEL	lower earnings limit (for National Insurance contributions purposes)
LPI	limited price indexation
LTA	lifetime allowance
MND	member-nominated director
MNT	member-nominated trustee
NICs	National Insurance contributions
NMPA	normal minimum pension age
NPA	normal pension age
NPD	normal pension date
NRA	normal retirement age
NRD	normal retirement date
Ombudsman	the Pensions Ombudsman
OPRA	the Occupational Pensions Regulatory Authority (the predecessor to the Pensions Regulator)
PA 1995	the Pensions Act 1995
PA 2004	the Pensions Act 2004
PCLS	pension commencement lump sum
PIA	pension input amount
PIE	pension increase exchange
PIP	pension input period
PO	the Pensions Ombudsman
PPF	the Pension Protection Fund
PRA	the Prudential Regulation Authority
PSA 1993	the Pension Schemes Act 1993

QROPS	qualifying recognised overseas pension scheme
Regulator	the Pensions Regulator
ROPS	recognised overseas pension scheme
RPI	the Retail Prices Index
RST	reference scheme test
S2P	the State Second Pension
SDLT	stamp duty land tax
SDRT	stamp duty reserve tax
SERPS	the State Earnings-Related Pension Scheme
SFO	statutory funding objective
SFP	statement of funding principles
SIP	statement of investment principles
SMPI	statutory money purchase illustration
SPA	State Pension Age
TKU	trustee knowledge and understanding
TPAS	the Pensions Advisory Service
TPO	the Pensions Ombudsman
tPR/TPR	the Pensions Regulator
TPs	technical provisions
TUPE	the Transfer of Undertakings (Protection of Employment) Regulations 2006
UEL	upper earnings limit (for National Insurance contributions purposes)
UFPLS	uncrystallised funds pension lump sum
VFM	value for money/members

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