CLIFFORD
CHANCE

Briefing note September 2015

UK Pensions Update: September 2015

1. Changes to short service refunds for money purchase benefits from October 2015

Changes to the preservation legislation will come into force on 1 October 2015, which amend the statutory right for certain early leavers to take a refund of contributions in respect of money purchase benefits.

Currently, individuals only gain a statutory right to a preserved benefit (i.e. a deferred pension) once they have accrued at least two years' qualifying pensionable service in a scheme. Those with between three months' and two years' qualifying service have a statutory right to take a contribution refund or a transfer-out.

However, amendments to the Pension Schemes Act 1993 made by the Pensions Act 2014, will mean that, from 1 October 2015, for certain early leavers, **only 30 days' pensionable service** will be needed to become entitled to a preserved benefit. These early leavers will no longer be able to take a contribution refund.

The policy intent behind the change is to address the Government's concerns that too many members who are being auto-enrolled will take a refund of contributions if they leave with less than two years' pensionable service and therefore fail to build-up sufficient pension savings in the long term.

Key Points

- This change will only apply to a member where **all of the benefits** to which the member would be entitled under the scheme would be "money purchase benefits" (within the meaning of section 181, Pension Schemes Act 1993). [1] Therefore, where a member has defined benefit (**DB**) benefits in another section of the scheme, they will continue to have a right to take a refund of contributions where they have less than two years' qualifying service.
- This change will only apply where the individual's pensionable service in the scheme started on

Key issues

or after 1 October 2015 **(i.e. they become an active member of the scheme on or after 1 October 2015**).

- This will not affect personal pension schemes as short service refunds are not available for these schemes at the moment (there is simply a cooling-off period in which the plan can be cancelled).
- This will not affect any schemes which **only** provide benefits that are **not money-purchase** (although, as most DB schemes have an additional voluntary contribution (**AVC**) facility, these schemes are likely to be few and far between).

What does this mean in practice?

- Both: (i) occupational money purchase schemes; and (ii) occupational schemes which provide money purchase benefits and other benefits, but have members who are entitled to money purchase benefits only, will only be able to make contribution refunds in respect of such members who join the scheme on or after 1 October 2015 where the member has less than 30 days' pensionable service. If a member leaves after 30 days, their rights will have already vested and, on leaving, they will become a deferred member (unless they choose to take a transfer).
- Employers with a high turnover of staff are likely to face increased costs where refunds can no longer be paid (because, generally, on a contribution refund, employer contributions remain in the scheme and can normally be used towards scheme expenses).
- Rules of affected schemes should be checked to see what they say about contribution refunds for early leavers as the preservation legislation is not automatically overriding. If rules cross-refer to the preservation legislation, the amendments made by the Pensions Act 2014 should automatically flow through so that no rule amendments would be strictly necessary. However, if rules have attempted to describe the statutory rights in their rules (based on the historic preservation requirements), but without cross-referring to the relevant legislation or requiring refunds to be in accordance with applicable legislative requirements, then rule amendments may be required.

2. APL writes to HMRC about VAT recovery requirements

As covered in our April 2015 briefing note entitled "*VAT and Pension Fund Management – the new guidance*" (accessible via the following link), in March of this year, HMRC published updated guidance relating to the deduction of VAT on DB pension fund management costs.

The basic premise of the guidance is that an employer can only recover VAT on scheme administration or investment management costs where there is evidence that the relevant services are provided to the employer and, in particular, the employer is a party to the contract for those services (i.e. there is a tripartite agreement between the supplier, the employer and the trustees) and has paid for them. The deadline for putting in place these tripartite agreements is currently 31 December 2015.

Given the difficulties this is likely to cause in practice (i.e. renegotiation of existing contracts, incurring legal fees and time), the Association of Pension Lawyers (**APL**) has written to HMRC to suggest an alternative approach. The APL is asking whether HMRC would accept schemes making an amendment to their trust deed and rules to confirm that the services required to operate the scheme are procured by the trustees in order to provide benefits to members of the scheme on behalf of the employer. This would achieve the requisite link between the services supplied and the employer, without needing to enter into a tripartite contract. The APL has also invited HMRC to grant an extension to the 31 December deadline due to the delay in providing further guidance. It is hoped that HMRC will respond positively to these suggestions. The APL wrote to HMRC at the end of July and HMRC's response is eagerly awaited.

3. PPF publishes guide to PPF levy 2015/2016

The Pension Protection Fund (**PPF**) published its guide to the Pension Protection levy last week – invoicing for the 2015/16 levy will take place this month.

The PPF publishes a guide to the levy every year. It's designed to help schemes understand their levy invoice and explains how the levy is calculated, how it should be paid and how to query an invoice.

This is the first year that the insolvency risk scores for employers have been carried out by Experian (rather than Dun & Bradstreet (**D&B**)). D&B used to produce a "failure score" for these purposes. Experian has developed its own scorecard system, which produces an "insolvency score".

This uses a methodology which has been created specifically for the PPF (developed using observed insolvencies amongst employers and guarantors of DB schemes). As this is a PPF-specific model, an employer with a particular Experian score for non-PPF purposes may well have a different Experian score for PPF purposes.

There is also a new appeals process in place this year and there is effectively a two-stage process for appealing Experian insolvency scores. If a complaint relates to an "appealable score" (the calculation of the mean score, levy band or levy rate), then an appeal should first be made to Experian. If unsatisfied with the outcome of the appeal, the applicant can then request a formal review to the PPF. This is new – under the old system, it was not possible to appeal to the PPF about a D&B failure score.

Most other things, including the deadline for appeals, method of payment, deadline for payment and accrual of interest during ongoing appeals, remain consistent with last year's guidance.

4. Pensions Regulator publishes details of its funding investigation into the DLR pension scheme

The Regulator has recently published its first report of this type into a scheme funding case. The report gives an insight into what action the Regulator might take where a scheme has missed the statutory deadline for agreeing its actuarial valuation.

The scheme trustees and statutory employer were unable to reach agreement on the scheme's actuarial valuation within the 15 month statutory deadline. Initially, the Regulator facilitated discussions between the parties, but this was unsuccessful. The Regulator subsequently issued a Warning Notice with a view to requesting skilled persons' reports on the scheme funding position and strength of the employer covenant to inform how it should use its powers under the scheme funding legislation. (The Regulator has wide powers to intervene under the scheme funding legislation, including to impose its own schedule of contributions in certain circumstances).

During its investigation, the Regulator encouraged the trustees to consider using the contribution power under the scheme rules to impose contributions outside the scheme funding framework. However, there was not an agreed interpretation of the scope of this power. Over a year after the Warning Notice was issued, the trustees did make a demand for contributions using this power and then brought court proceedings to enforce payment. This led to a settlement agreement being reached pursuant to which the funding deficit of £36.1m as at 1 April 2012 would be cleared by January 2018, with over £20m to be payable by January 2016.

It is clear from this case that the Regulator does not take a positive view of late valuations (in its report, the Regulator refers to having a "low tolerance" of them). However, the focus of the Regulator's involvement in these cases seems to be first on encouraging collaboration between the trustees and employer to reach agreement, as well as encouraging the use of any powers available under the scheme rules to avoid the need for regulatory intervention, before it considers taking any enforcement action. (The Regulator did issue a Warning Notice in this case, but not until two years after the statutory deadline for agreeing the valuation had passed. The Regulator notes that this route of obtaining skilled persons' reports is likely to be appropriate in non-compliance situations where the parties are not taking "urgent positive steps" to remedy the non-compliance in a timely way).

The approach taken in this case is consistent with the DB funding regulatory and enforcement policy (published in June 2014), which makes some comments about late valuations and failure to agree, in particular:

- If the Regulator receives advance notification that the valuation is unlikely to be completed on time, it will generally not engage at that point if work is underway.
- The Regulator's objective is to facilitate discussions between parties and encourage the trustees and employer to engage and agree an achievable timetable within which they can agree an appropriate outcome.
- Where the delay is likely to be short, the deadline has only just passed or the Regulator is confident that good progress is being made, the Regulator is unlikely to take enforcement action.

5. Pensions Regulator publishes updated guidance on assessing and monitoring employer covenant

On 13th August, the Regulator published updated guidance for DB schemes on assessing and monitoring the employer covenant,

which replaces previous guidance published in 2010.

The guide gives practical guidance for trustees of DB schemes on how to assess and monitor the covenant and take action to improve scheme security. It includes suggested lists of questions and several practical examples to assist trustees in conducting a covenant review.

The guidance does not add anything fundamentally "new" (and most of the points covered in the new guidance are things trustees will already have been thinking about when assessing employer covenant), but is more extensive and detailed in relation to certain concepts, for example, setting out additional considerations for schemes sponsored by not-for-profit organisations and non-associated multi-employer schemes.

It is likely the new guidance will prompt trustees to review their processes for covenant assessment and update them. It may also cause more trustees to seek external advice.

In terms of future developments, the guidance is said to be the first in a series of guides for scheme trustees to help them apply the DB funding Code of Practice. The Regulator intends to produce further guidance to help trustees navigate the DB Code later this year.

6. Pensions Ombudsman determination gives comfort to schemes waiting to equalise GMPs

The Ombudsman's determination in the recent case of ***Kenworthy v Campden R.A. Pension Trust Limited and Trigon Pensions Limited (PO-4579)*** gives some comfort to schemes which have not yet equalised their Guaranteed Minimum Pensions (**GMPs**).

In this case, the Ombudsman took the view that failure to equalise GMPs was reasonable and that the scheme in question could continue to defer taking action to equalise GMPs whilst this issue remains generally unresolved.

The case concerned a complaint from a member that his deferred pension had been calculated incorrectly – both under the scheme rules and contrary to sex equality legislation. The member had received an estimate of his benefits available at age 65. In the benefit statement, it was explained to the member that there was no legal obligation to equalise GMPs in the scheme.

The trustees said that they did not consider it appropriate to take steps to equalise GMPs while the position under the law is still unclear. However, they were actively monitoring developments in this area and will continue to do so.

The Ombudsman concluded that, apart from the GMP benefits, the pension benefits in the scheme had been equalised for men and women. The Ombudsman took the view that failure to equalise GMPs was reasonable and the scheme can continue to defer taking action to equalise GMPs whilst this issue remains generally unresolved.

Although the Ombudsman's decision does not add much to the current picture, it might at least give some comfort to schemes which have not yet equalised their GMPs that the Ombudsman thinks it reasonable to postpone any action in light of the current uncertainty as to how this would be achieved.

In terms of an update on GMP equalisation more generally, in its consultation response on the ***Occupational Pension Schemes (Schemes that were Contracted-out) Regulations*** (published in July), the DWP has said that GMP equalisation issues "are being explored separately" but has not given any further clues about the timescale involved.

7. Update on IORP II

Over the summer, the European Parliament's Economic and Monetary Affairs Committee (**ECON**) published a report, containing suggested amendments to the draft IORP II Directive.

A couple of the proposed amendments (if they make it through to the final version of the Directive) could raise some potential issues for UK schemes. In particular:

- **Transfers** – one of the proposed amendments is that member consent should be required for all pension transfers (both cross-border and domestic), which would essentially prohibit without-consent bulk transfers which are currently permitted in certain circumstances in the UK. Although less of a concern, this would also cause a problem for the "pot-follows-member" approach being proposed for the future.
- **Funding** – the report proposes that the requirement for cross-border schemes to be fully funded at all times be replaced with a requirement for full funding "at the moment" the IORP "starts operating a new or additional scheme". Removal of the requirement for cross-border schemes to be fully funded at all

times is something which has been pursued for a while. However, the report is proposing that the requirement for full funding at the start of operation apply to all IORPs (domestic schemes as well as cross-border ones). Extending it in this way could cause an issue (depending on the interpretation of "starts operating a new or additional scheme") by catching domestic schemes where e.g. there is a scheme merger or a new section is added to an existing scheme,

Other, more welcome, proposed amendments include:

- **Solvency II** – new recitals to make clear that the further development of a solvency models is not realistic and no quantitative capital requirements should be developed at EU level in relation to IORPs.
- **"Fit and proper" requirements** – amendments to remove the need for professional qualifications for those running schemes and requiring experience to be "collectively adequate".
- **Pension benefit statements** – a proposal that the Directive set out guiding principles on the information to be included in the annual benefit statement, rather than a prescriptive set of rules.

The report is only in draft form at this stage and ECON is due to finalise it in the autumn. It's also important to be aware that these amendments may not make it into the final version of the Directive – there has been a lot of back and forth on IORP II so far, and there are a lot of moving parts still at this stage. In particular, regarding the transfer point above, some are saying that this amendment has been suggested without realising that without-consent transfers are currently permitted in the UK.

In terms of timing, originally IORP II was due to be finalised and implemented into national law by 31 December 2016. However, this timescale has been removed from the latest draft of the Directive, which simply requires member states to transpose the Directive into national law within two years of the date the Directive comes into force. Given that the text of the Directive itself hasn't yet been finalised, it seems that any difficulties caused by IORP II are a way off yet.

8. Government launches consultation on pension transfers and early exit charges

At the end of July, the Government published a consultation paper on pension transfers and early exit charges. In particular, the consultation is focusing on:

- Issues around early exit charges (i.e. charges for either transferring-out or accessing benefits flexibly before normal pension age) and whether or not imposing a cap on these charges for those aged 55 and over would be a good idea.
- Seeking views on the statutory transfer process for flexible benefits and whether this could be made quicker and smoother.
- How to ensure there is greater clarity around when the independent financial advice requirement on certain transfers applies (the consultation paper notes that there have been reports of some schemes requiring members to take advice even though their benefits are worth less than £30,000).

The consultation is a move by the Government to ensure that individuals can take advantage of the new defined contribution (**DC**) flexibilities easily and without facing high charges. The consultation closes on 21 October 2015 and the response is expected to be published at some point this autumn.

9. Update on British Airways

Judgment was recently handed down in the case of ***British Airways plc v Spencer & others [2015] EWHC 2577***. This concerned BA's appeal against a case management decision not to allow expert evidence to be called or relied on.

The Deputy Master had concluded that this was not a case where expert evidence should be admitted. In his judgment, Mr Justice Warren decided that the Deputy Master's wholesale decision to reject any expert evidence was flawed and should be set aside. He concluded that there are areas where actuarial evidence may be of some assistance to the court and should therefore be admitted. There are also areas where actuarial evidence is necessary to resolve particular issues.

Although the judgment related to a procedural point rather than anything more substantive, it did confirm that the trial for the main proceedings is fixed for 25 days in February 2016.

The main proceedings relate to a claim made by BA in December 2013 against the trustees of the scheme. This followed a decision by the trustees to amend the scheme rules in response to the Government's decision in 2010 to change the index used for statutory minimum pension increases and revaluation from RPI to CPI. (The scheme rules required

increases by reference to The Pensions Increase (Review) Order so CPI automatically flowed through). In 2011, the trustees amended the rules to require a review to pension increases once a year, with a trustee power to grant discretionary increases. An additional increase of 0.2% was then granted in February 2013.

BA's claim is that the decision to amend the scheme rules to introduce a discretionary increase power was invalid because it involved the exercise of the amendment power for an improper purpose. The trustees' decision to then use this power to award additional increases is also being challenged on the basis that the trustees failed to give genuine consideration to the exercise of their discretion and again, exercised the power for an improper purpose.

10. Consultation on reforms to pensions tax relief closes at the end of this month

As discussed in the July 2015 edition of this UK: Pensions Update, the Government has been consulting over the summer on whether there is a case for reforming pensions tax relief to incentivise pension saving. The deadline for responding to the consultation is the end of this month and it has stirred up a lot of interest so far.

The Government is asking for views on various options for reform, with one proposal to move to an ISA-style "Taxed-Exempt-Exempt" ("**TEE**") system (i.e. away from the "Exempt-Exempt-Taxed" system we currently have). Under a TEE system, individuals would lose tax relief on contributions into a pension scheme, but withdrawals would be tax-free (and in between, savings would receive some form of top-up from the Government – although it is not yet clear what the extent of this top-up would be).

Views being expressed across the pensions industry include the following:

- In order to encourage people to save for retirement, there needs to be an incentive which makes it more attractive than other, short-term, savings. It is difficult to see how a move to a TEE style system would achieve this.
- Making further radical changes to our pensions system raises concerns that people will lose faith in it and therefore be discouraged from contributing to their retirement saving.
- Concerns are being expressed over the stability of any reforms – what if we move to a TEE system and a successor Government decides pension income should be taxed again – is there a risk of double taxation?
- Hope that any reforms could simplify the current somewhat complex and opaque system (with many people not understanding how the current system of tax-relief works).

It is hoped that any reforms will not be rushed through.

[1] Or collective benefits, or benefits calculated otherwise than by reference to the member's salary.

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