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CHANCE

Briefing note

February 2017

UK: Pensions Update February 2017

Welcome to the February 2017 edition of the UK: Pensions Update.

In this edition we focus on some key contracting-out developments (including the new proposed methodology for GMP equalisation); the Select Committee's report recommending stronger DB scheme regulation and recent developments involving the Regulator.

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1. Select Committee recommends tougher DB regulation

The House of Commons Work and Pensions Select Committee has published a report concluding its inquiry into defined benefit **(DB**) pension schemes. This sets out recommendations for changes to DB scheme regulation; which the Committee urges the Government to take forward in its forthcoming pensions Green Paper.

The Committee's recommendations include the following:

- **Compulsory clearance**: to consult on rules to make clearance mandatory for certain corporate transactions.
- **Punitive fines**: to give the Pensions Regulator powers to add punitive fines to Contribution Notices and Financial Support Directions at treble the level of the original demand. The intention is that such fines would not need to actually be imposed – "*they would act as a nuclear deterrent to avoidance*."
- **Consolidation**: to give scheme trustees (with Regulator approval) powers to consolidate small schemes in an aggregator fund to be managed by the Pension Protection Fund (**PPF**).
- **Indexation**: to give scheme trustees (with Regulator approval) powers to agree changes to the indexation of pension benefits in instances where changes are needed to make a scheme sustainable, including conditional arrangements that will revert to the original level of indexation 'when good times return'.
- **Valuation cycles**: to reduce the statutory timescale for submitting valuations and recovery plans from 15 months to 9 months.
- **Recovery plans**: to place the onus on sponsoring employers to demonstrate that a recovery plan is reasonable in their specific circumstances and to ensure that recovery plans of more than 10 years are 'exceptional'.
- **RAAs**: to consult on streamlining the regulated apportionment arrangement process.
- **Regulator's wind-up powers**: to broaden the Regulator's power to wind-up a pension scheme to circumstances where the Regulator is satisfied this would be in the best interests of the PPF and its levy payers and that no alternative option is realistically available to deliver a better outcome for members.
- **PPF**: to consult on adjusting the calculation of the PPF risk-based levy.
- **Cash lump sums**: to consult on relaxing the rules for taking small DB pensions as lump sums.

At this stage, it remains to be seen whether any of these recommendations will be taken forward by the Government in its forthcoming Green Paper (or indeed at any point in the future). While some of the proposals, if properly implemented, might be welcomed by some in the pensions industry (for example, flexibility of indexation); others could cause significant problems in practice. For example, the requirement for compulsory clearance on corporate transactions could slow down corporate activity if the parameters around when it would be compulsory are not sufficiently narrowly drawn.

2. Warning Notice targets refused judicial review

Claimants in the Silentnight anti-avoidance case[1] have been refused permission to bring judicial review proceedings against the Pensions Regulator.

This case related to the acquisition of the Silentnight business by a private equity firm in 2011. Silentnight's pension scheme was in deficit and the sale resulted in the business being separated from the scheme. The scheme remains in deficit and is now likely to enter the PPF.

The Regulator began an investigation and considered the business had been sold at an undervalue; with the scheme losing out as a result. In 2014, the Regulator issued a Warning Notice against a number of those involved, warning of its intention to seek a Contribution Notice requiring £17.16m to be paid to the scheme. The Regulator issued another Warning Notice in 2016, which was accompanied by new evidence and documents.

The targets applied for permission to seek judicial review against the second Warning Notice on the basis that it was unlawful – either because it was issued at a time when the first Warning Notice was still outstanding or because the process leading up to its issue had been unfair and 'lacking in even-handedness'.

The matter came before the Administrative Court in December and the judgment was recently published. Ultimately, the judge refused the judicial review application.

Central to this decision was that the targets had an alternative remedy – they could instead proceed to the Regulator's Determinations Panel and then the Upper Tribunal. The issuance of Warning Notices was still part of the Regulator's investigatory phase and did not necessarily represent its final position.

While there have been cases permitting judicial review notwithstanding the existence of an alternative remedy; the judge commented that these were exceptional. The Silentnight case was not exceptional and the targets' arguments about the process being unlawful would be much better determined by those close to the case (i.e. the Regulator's Case Team, Determinations Panel and the Upper Tribunal).

While an interesting case, the decision is not particularly surprising. A relevant factor which seemed to play a role in the judge's decision was concern over opening the floodgates for judicial review applications for others in similar situations – something which would clearly be undesirable, particularly where there is a clear, alternative procedure in place.

3. Deadline for GMP revaluation resolutions approaching

Schemes looking to use the statutory modification power[2] to align their Guaranteed Minimum Pension (**GMP**) revaluation rules with the contracting-out legislation will need to take action **before 6 April 2017.**

The statutory power allows trustees to pass a resolution to bring scheme rules in line with the legislation, which was amended from 6 April 2016 to reflect the abolition of contracting-out. (For more background, please see the May 2016 edition of UK: Pensions Update).

Resolutions can have backdated effect to 6 April 2016 and use of the power does not require prior consultation with employees. This power will be useful for schemes which use fixed rate revaluation and without the power would be unable to amend their rules due to restrictive amendment powers.

In related news, the Government recently launched a consultation on further amendments to the contracting-out legislation and a proposed methodology for GMP equalisation.

The consultation

The amendments proposed are mainly technical, tidy-up changes to the contracting-out legislation, which are intended to come into force from April 2017.

Of more interest is the new method which has been proposed for equalising GMPs. As those in the pensions industry will be well aware, the uncertainty around if, when and how GMPs should be equalised has been ongoing for some time now. The Brexit vote last June only served to further this uncertainty.

In this consultation, the Government is seeking views on a new method which would involve a one-off calculation and actuarial comparison of the benefits a man and woman with the same pensionable service history would have, with the greater of the two converted into an ordinary scheme benefit under the existing GMP conversion legislation (to which some changes are being suggested). This would be carried out on an individual member basis.

[1] *R (Grace Bay II Holdings Sarl and others) v The Pensions Regulator and others [2017] EWHC 7 (Admin).*

[2] Under regulation 7C of *the Occupational Pension Schemes (Modification of Schemes) Regulations* 2006.

The consultation paper makes clear, however, that there would not be an obligation on schemes to use this method, nor does it comprise legal advice to schemes on how to equalise: "*it should not be treated as a definitive statement of how equalisation should be effected*".

If this new method is to be endorsed by the Government, schemes are likely to want some reassurance that it is legally compliant and that, by adopting it, they will not be at risk of future challenge. At this stage, there are still a number of issues with the method which need to be worked through and the Government's response to the consultation is currently awaited. Further developments on this are therefore likely this year.

4. Settlement in Coats anti-avoidance case

A recent announcement by the Pensions Regulator gives an insight into a case where its intervention led to a £255.5m settlement; meaning a formal exercise of its powers was no longer necessary.

In this case the Regulator had issued Warning Notices setting out a case for exercising its Financial Support Direction powers in relation to three DB schemes within the Coats group.

However, following negotiations with Coats, the Regulator secured a settlement in respect of two of the schemes. The settlement reportedly involved: (i) upfront payments totalling £255.5 million into the two schemes; (ii) a change in the statutory employer to improve the covenant support; and (iii) a full parent company guarantee. The Regulator reports that a comparable offer has been made to the trustees of the third scheme and discussions are ongoing.

The Regulator commented that this was a substantial settlement and shows that "*we can and will use our existing powers against a solvent employer if that is the right thing to do*".

The Regulator recently came under scrutiny from the Work and Pensions Select Committee for being slow to act in its investigation into BHS. It seems likely this may have prompted the Regulator to be more vocal about cases where its intervention has led to an improved settlement for a scheme without needing to proceed to a formal exercise of its powers.

5. Judicial Pension Scheme discrimination claims successful

A recent Employment Tribunal case [3] resulted in discrimination claims regarding the Judicial Pension Scheme (**JPS**) being upheld.

The JPS was closed in 2015 and replaced with a new scheme which provided less generous benefits. Under the rules of the new scheme, older judges were permitted to remain members of the JPS either until retirement or until the end of a tapered protection period. Whether or not a judge fell into one of these categories depended entirely on their age.

A group of c.200 judges brought discrimination claims; arguing that the rules amounted to direct age discrimination and indirect sex and race discrimination and breached the principle of equal pay.

The Government sought to argue that the rules could be objectively justified i.e. they were a proportionate means of achieving a legitimate aim. The key aim asserted was to protect those closest to retirement from the financial effects of pension reform.

The Tribunal held that the provisions were discriminatory and the Government had failed to objectively justify them.

Key to reaching this decision was that the Government had said the aim was to protect those older judges who were closer to retirement from the financial effects of pension reform. However, there was no evidence this was true and in practice, older judges were less affected by the reforms as they would have accrued greater pension benefits under the more generous scheme. As a result, there was no legitimate aim.

The Tribunal also commented that, even if the aim had been legitimate, the provisions were not proportionate given the severe financial impact they had on younger judges.

This case provides some useful insight into what is needed to establish a successful objective justification defence. In particular, it highlights the importance of demonstrating a clear, legitimate aim, which is supported by evidence and specific analysis – rather than mere speculation or unfounded generalisations.

6. Citysprint cycle courier deemed 'worker'

Following the recent case involving Uber drivers who were deemed "workers" (as reported on in our last edition of UK: Pensions update), another similar case has now been heard before the Employment Tribunal.

This case [4] concerned a cycle courier for Citysprint who made a claim for holiday pay. As in the Uber case, the Tribunal held that the courier was a worker and therefore entitled to holiday pay. Having looked at the relationship between the courier and Citysprint as a whole, the Tribunal reached this decision based on the fact that, overall, the courier had little autonomy to determine the manner in which her courier services were performed and no chance

[3] *McCloud and others v Lord Chancellor and Secretary of State for Justice and another ET/2201483/2015*.

[4] *Dewhurst v Citysprint UK Ltd ET2202512/2016.*

at all to dictate the terms.

This is the latest case involving so-called "gig" economy workers and is unlikely to be the last. As well as having employment implications, it is likely to have pensions implications in the context of auto-enrolment. Following the Uber decision, it was reported that the Pensions Regulator would be looking closely at the judgment and considering whether Uber would be required to auto-enrol drivers. The Citysprint decision is likely to mean the scope of this review will extend more widely to all "gig" economy workers.

7. Data protection issues continue to develop

The decision of the European Courts in October 2015 to rule the US "safe harbor" regime invalid meant this could no longer be relied on for transfers of personal data from the EEA to the US.

Since then, a couple of alternative methods have been used:

(a) **The privacy shield**, which became operational from August 2016 and was introduced as a replacement for the safe harbor regime. This introduced a number of privacy principles which companies must abide by and commitments by the US government on how the arrangement will be enforced; and

(b) **The standard EU model contractual clauses**, which are used for the transfer of personal data outside the EEA generally (including to the US).

However, there is still movement in this area and an Irish High Court case due to be heard this month looks to challenge the use of EU model contractual clauses as a safe way to transfer personal data to countries outside the EEA. The privacy shield regime has also faced criticism from privacy activists on the basis that it does not do enough to adequately protect personal data from US governmental access.

Alongside all of this is the new EU Regulation on data protection – the General Data Protection Regulation (**GDPR**), which will take effect on 25 May 2018.

There is uncertainty around how long the GDPR will apply to the UK; something which will depend on the outcome of Brexit negotiations. However, in the meantime, it is not something which should be ignored and data protection generally is likely to be a high priority for pension scheme trustees. Key elements of the new GDPR include:

- **Expanded scope** – it will apply to data controllers established in the EU, but also to data processors and organisations outside the EU offering goods or services to EU data subjects or monitoring their behaviour.
- **One-stop shop** – appointment of a lead data protection authority to deal with issues in the context of pan-European data processing.
- **Accountability** – data controllers will need to take various steps (through policies, privacy impact assessments, etc) to demonstrate compliance.
- **Penalties** – fines for non-compliance will have the potential to be much higher than currently.

Trustees may therefore want to start thinking about how the GDPR will affect their existing data protection arrangements and what changes they will need to make to ensure GDPR compliance. It is hoped there may be some guidance forthcoming from the Information Commissioner's Office regarding the application of the GDPR to those in the pensions sector.

8. Regulator expresses views on 21st Century trusteeship

The Pensions Regulator recently published a response to its discussion paper on 21st Century trusteeship – a paper designed to stimulate dialogue about how to improve standards of trustee competence and improve scheme governance and administration.

The Regulator has said its focus will be on trustees who need support; through education, and increased use of the Regulator's enforcement powers; targeted at poorly run schemes.

The Regulator commented that few respondents thought mandatory qualifications would be appropriate for lay trustees or chairs (with concerns this would discourage trustee volunteers). Instead, respondents were in favour of continuing trustee training and development.

The Regulator says it will aim to drive up standards through: (i) more targeted education and tools; (ii) setting out clearly what is meant by the higher standards the Regulator already expects of professional trustees and the specific qualities and skills it expects of trustee chairs; and (iii) tougher enforcement against trustees who fail to meet the required standards. The Regulator expects to start its education campaign in the spring.

Another theme prominent in the Regulator's paper is the difficulties faced by small schemes. Although the paper only touches upon the potential for consolidating small, poorly-run defined contribution (**DC**) schemes into quality master trusts, the drive towards consolidation of smaller schemes is something which seems to be gathering momentum more generally; with the Work and Pensions Select Committee recommending consolidation of smaller schemes in its recent report on DB schemes (discussed in more detail above).

9. Key legislative developments

- **LISA:** The Lifetime ISA will be available from April 2017 as *the Savings (Government Contributions) Act 2017* received Royal Assent on 16 January 2017.
- **IORP II**: the IORP II Directive[5] came into force in January and member states will have until 13 January 2019 to implement it into their national laws. Given the progress of the Brexit timetable to date, it is highly likely the UK will be required to implement IORP II – even if only for a short time. Many of the requirements in IORP II are already reflected (at least to some extent) in current UK pensions legislation, such that its implementation should not be too problematic. In addition, a number of the problems with earlier drafts (regarding e.g. transfers, funding and the need for trustees to have professional qualifications) have been resolved in the final version. IORP II does, however, introduce a couple of new themes relating to intergenerational fairness and consideration of environmental, social and governance factors in the investment context. These provisions are not particularly prescriptive and it will be interesting to see how they are interpreted by the UK in its implementation of IORP II. Enhanced governance and disclosure requirements in IORP II may also necessitate changes.
- **EMIR**: The European Market Infrastructure Regulation (648/2012) (**EMIR**), which came into force in August 2012, requires over-the-counter (**OTC**) derivatives to be cleared. However, certain pension scheme arrangements benefit from an exemption which means they do not have to comply with this clearing obligation. This exemption was originally due to expire on 16 August 2015, but was subsequently extended until August 2017, and more recently, extended again until 16 August 2018. This was on the basis that central counterparties need additional time to find solutions for pension funds. There is also to be a legislative review of EMIR this year, which may look at whether the pensions exemption could be prolonged or even made permanent.

  On a related note, other rules which have recently been finalised will impose new margin obligations in respect of non-cleared OTC derivatives. The new rules for variation margin come into force generally for trades from 1 March 2017 (although a slightly earlier date applies for dealers with outstanding trades in excess of EUR 3 trillion) and will also apply to certain pension scheme arrangements entering into such transactions. Derivatives documentation will need to be compliant with the new collateral rules.
- **Pension Schemes Bill 2016/17**: the Bill, which will introduce a new regime for the regulation of master trusts, had its second reading in the House of Commons on 30 January. There has not yet been an indication of a targeted date for the provisions to come into force and much of the detail backing the Bill is to be set out in regulations. Further developments on this are likely in the coming months.
- **Finance Bill 2017**: the Government is currently consulting on the draft *Finance Bill 2017* (the consultation closed on 1 February 2017). This includes: (i) legislation covering the £500 employer-arranged pensions advice exemption; and (ii) changes to the tax treatment of foreign pension regimes. The Government will legislate separately to reduce the money purchase annual allowance, pending the outcome of a separate consultation on this (which closes on 15 February 2017). Timing wise, the Government has said the final contents of the Finance Bill will be subject to confirmation at the Budget on 8 March.

10. Government consultations and reviews

(1) DC bulk transfer requirements

- The Department for Work and Pensions (**DWP**) has launched a consultation seeking views on how the current rules on the bulk transfer of DC pensions without member consent could be improved.
- This seems to be driven by a desire to encourage consolidation of smaller DC schemes on the basis that they may be less well run and/or impose higher charges than larger schemes.
- Specifically, the consultation is considering how to: (i) reduce unnecessary burdens whilst ensuring adequate member protection; and (ii) allow stakeholder pension providers to transfer members to more modern and lower cost schemes.
- For bulk transfers without consent between **occupational DC schemes**, the consultation is looking at the suitability of the current requirement for an actuarial certification confirming that members' rights in the receiving scheme would be "*broadly no less favourable*" than the rights to be transferred. The paper suggests other measures may be more appropriate, including a comparison of the transferring and receiving scheme in terms of governance, charges, investments and retirement options.
- For bulk transfers without consent from **stakeholder schemes**, it is suggested that the current requirement that transfers can only be made to other stakeholder schemes is outdated. The consultation is considering

[5] *Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision*.

whether transfers from these schemes should be allowed to take place to other types of scheme (e.g. individual or group personal pension schemes).

- The consultation is not considering any changes to the requirements for bulk transfers of **DB pensions** without member consent.
- The consultation closes on 21 February 2017. It is intended that the information gathered from this consultation will then inform another consultation on firmed up policy proposals during 2017. Any new legislation is currently targeted for April 2018.

(2) New financial guidance body

- HM Treasury and the DWP are seeking views on creating a single body to provide debt advice, money guidance and pensions information and guidance.
- The consultation closes on 13 February 2017 and the aim is for the new financial guidance body to be in place after autumn 2018. The new body will incorporate the best of the Money Advice Service (**MAS**), The Pension Advice Service (**TPAS**) and Pension Wise.
- The service will cover: (i) debt advice; (ii) guidance and information on matters relating to occupational or personal pensions, accessing DC pots, and planning for retirement; (iii) providing information to help consumers avoid financial fraud and scams; (iv) guidance on wider money matters and co-ordinating and influencing efforts to improve financial capability; and (v) co-ordination of non-governmental financial education programmes for children and young people.
- Until the new body comes into operation, the MAS, TPAS and Pension Wise will continue to operate as normal.
- Changes to the legislation which currently require schemes to signpost members to MAS, TPAS or Pension Wise will be necessary.

(3) Pension scams

- The Government is consulting on measures to tackle pension scams, which include (i) imposing a ban on pensions cold calling; (ii) limiting members' statutory transfer rights; and (iii) making it harder for fraudsters to open new schemes.

Cold Calling

- The paper proposes implementing a legislative ban on all cold calls in relation to pensions. The Information Commissioner's Office will be able to use its enforcement powers to impose sanctions on firms who breach the ban; including powers to issue fines of up to £500,000.

Limiting transfer rights

- The paper acknowledges that under current legislation trustees are in a difficult position when faced with a suspicious transfer. This is because to refuse the transfer, trustees must be able to show that it falls outside of the requirements set out in the legislation and therefore, there is no statutory right to transfer. Often, it can be difficult to prove the receiving scheme is not a legitimate scheme and that the member has no statutory transfer right.
- This was demonstrated by a recent High Court case.[6] In this case, there was no earnings link between the member and the employer of the receiving scheme, but this alone was held to be an insufficient basis for blocking the transfer (the legislation requires the individual to be an 'earner', but not an earner in relation to the receiving scheme). Therefore, while it had previously been suggested that the absence of such an earnings link may be a good indicator of a fraudulent scheme, this is not currently catered for in the legislation.
- To tackle this, the Government is proposing to limit members' statutory transfer rights so they would only apply where:
  - (a) The receiving scheme is a personal pension scheme operated by a provider authorised by the Financial Conduct Authority;
  - (b) The receiving scheme is an occupational pension scheme and there is a genuine employment link to that scheme; or
  - (c) The receiving scheme is an occupational pension scheme which is an authorised master trust.
- The consultation is alternatively considering less significant changes, including a new retirement for 'insistent' members looking to transfer to sign a discharge declaration; limiting their recourse to the transferring scheme. While this may be preferable from a trustee perspective, it is difficult to see how this adds much to the current regime; with many schemes already requiring members to sign a discharge form on transfer confirming they have been provided with the appropriate scam warnings.

Opening new schemes

- The Government is proposing to revise the HMRC registration process to only permit active companies (and not dormant ones) to register a new pension scheme. The Government is also looking at whether additional steps should be taken to limit pension scams through small self-administered schemes.
- The consultation closes on 13 February 2017. It will be interesting to see the outcome, particularly regarding

[6] *Hughes v The Royal London Mutual Insurance Society Limited [2016] EWHC 319 (CH).*

the reformation of statutory transfer rights; which is likely to have significant implications for trustees and how they deal with transfers going forwards.

(4) Government to review auto-enrolment this year

- The DWP has announced it will review auto-enrolment in 2017. The review will look at who is covered by auto-enrolment; with a focus on ensuring that auto-enrolment continues to meet the needs of individual savers.
- In particular, the review will look at those not currently benefitting from auto-enrolment e.g. employees with multiple jobs who do not meet the auto-enrolment criteria in any of these; employees with earnings below the trigger threshold and the self-employed.
- The review will also cover the statutory review of the alternative quality requirements for DB schemes, the certification requirements for DC schemes and the level of the charge cap.
- The Government expects to publish a report setting out policy recommendations towards the end of this year.