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Briefing note

May 2017

UK: Pensions Update

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

In this edition we focus on plans recently announced by the Prime Minister to protect pensions by giving the Pensions Regulator more power, the pensions Green Paper published earlier this year and new legislation in the form of the Pension Schemes Act 2017 and the Finance Act 2017.

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1. Prime Minister pledges to protect pensions

Over the weekend, Theresa May announced plans to introduce new powers for the Pensions Regulator to scrutinise takeovers and dividend payments involving employers in pension schemes.

Pledged as part of the Conservative Party's manifesto in advance of the general election next month, the Prime Minister has said the plans would require a company pursuing a merger or acquisition valued over a certain amount or with over a certain number of members in a pension scheme to notify the Pensions Regulator, who would in turn be given new powers to block the transaction in certain circumstances (although details of the proposed scope of these new powers have not yet been made public). The powers would be designed to prevent a repeat of the recent high profile case involving the collapse of BHS.

The announcement follows the Government's Green Paper on pensions published earlier this year (and discussed in more detail below) which floated the idea of making Pensions Regulator clearance compulsory on certain corporate transactions. The paper was published as a discussion paper and aimed to seek views on various pensions proposals. However, Theresa May's recent announcement indicates that, if elected, this is something the Conservative Government will actively pursue.

2. Pension Schemes Bill and Finance Bill receive Royal Assent

Last week, both the Pension Schemes Bill and the Finance Bill received Royal Assent; becoming the Pension schemes Act 2017 and the Finance Act 2017 respectively.

The Pension Schemes Act 2017 introduces a new regime for the regulation of master trusts. However, many of the key provisions are not yet in force and much of the detail backing the regime is to be specified in regulations which have not yet been made. The Government has indicated that its intention is to commence the provisions of the master trust authorisation regime in full in October 2018 (with consultation on the draft regulations required prior to this).

The Finance Act 2017 introduces amendments to the tax treatment of foreign pensions paid to UK residents and a new tax charge on transfers from UK pensions to Qualifying Recognised Overseas Pension Schemes (unless the transfer satisfies certain exceptions).

However, the Finance Bill was fast-tracked in light of the upcoming general election and this meant that a number of the pensions provisions originally tabled for inclusion were left out at the last minute, including:

- Provisions to reduce the money purchase Annual Allowance from £10,000 to £4,000 backdated to 6 April 2017; and
- Provisions to introduce an exemption from income tax for up to £500 of employer-arranged pensions advice.

The Government has indicated it remains committed to these provisions and will seek to legislate for them at the earliest opportunity.

3. PPF consults on new levy rules for next three years

The Pension Protection Fund (**PPF**) recently launched a consultation on new levy rules for the next triennium. The proposals are primarily aimed at achieving a more accurate assessment of insolvency risk (something the PPF is particularly concerned about in light of recent high profile insolvencies) and how the levy is shared across schemes; rather than the actual sum to be collected.

Key proposals include:

- **Employer scorecards**: proposals designed to improve predictability of insolvency and to use a company's credit ratings, where available, to generate insolvency risk scores.
- **Small schemes**: asking for views on areas which could be improved/simplified to help smaller schemes given the PPF's experience that small schemes face difficulties in engaging with the levy rules because they generally lack resources to obtain the specialist actuarial and legal advice needed on levy issues and risk reduction measures.
- **Certification of deficit reduction contributions (DRCs)**: looking at whether to amend the approach for certifying DRCs to make it simpler for all schemes.
- **Certification of Type A contingent assets**: requiring a guarantor strength report to be obtained by trustees in advance of certifying high value (£100m+) Type A contingent assets (group company guarantees).
- **Full review of contingent asset agreements**: to undertake a full review of the wording of the PPF's standard-form agreements for all contingent assets. The PPF's intention is for all newly certified contingent assets for the 2018/19 levy year to be in the new standard form and for existing contingent assets to be amended or re-executed on the new terms.
- **Schemes without a substantive sponsor (SWOSS)**: the PPF separately consulted on how to treat schemes without a substantive sponsor in February. The consultation ran for a short period and the PPF recently published its policy statement in response, together with a new levy rule to be included for the 2017/18 levy year. In the latest consultation the PPF is still encouraging views and comments on the rules for SWOSSs, so that any changes can be fed into the rules for 2018/19.
- **Levy discount to reflect good governance**: following up on a recent recommendation from the Work and Pensions Select Committee, the PPF is considering how it could offer a levy discount for well governed schemes.

The consultation closes on 15 May and is expected to be followed by a second consultation later this year; with the rules to be finalised in time to come into force for 2018/19. The proposal to require all existing contingent assets to be amended or re-executed on new standard terms would be particularly significant if implemented.

4. Government publishes pensions Green Paper

The Government published a Green Paper at the end of February which outlines a number of perceived issues with the current regime of defined benefit (**DB**) pension regulation and is asking for views to start an *'informed discussion on the best way forward*'.

The paper says upfront that the "*main conclusion is that there is <u>not</u> a significant structural problem with the regulatory and legislative framework*", so it is possible that the outcome of the paper may be little (or no) change to the current system (though note the Prime Minister's recent announcement regarding plans to give the Regulator more power – as discussed above).

The paper focuses on four key areas:

1. **Funding and investment**: the paper touches upon the current triennial valuation cycle and whether the 15 month period for finalising valuations should be reduced, as well as whether 'high risk' schemes should be required to produce more regular valuations. There is also some discussion around whether schemes are adopting investment strategies which are too cautious, resulting in sponsors having to pay more than they would otherwise.
2. **Scheme affordability**: the Government says it is not persuaded there is a general affordability problem for the majority of DB scheme employers and therefore it does not agree that action 'across the board' is necessary. However, it talks about a number of potential options for 'stressed' schemes/sponsors, including potentially widening the criteria for regulated apportionment arrangements so they are available to more sponsors/earlier; cutting or renegotiating benefits (including via a reduction to revaluation and indexation

rates, or suspension for a period); giving the Pensions Regulator a separate power to separate the scheme from the sponsor or wind-up schemes; and more intensive support from the Regulator.

3. **Member protection**: the paper floats the idea of making Pensions Regulator clearance compulsory on corporate transactions. However, the paper is clear that a blanket requirement to this effect would be disproportionate, and that the Government would consider this in a very narrowly limited set of circumstances only.
4. **Consolidation**: the paper talks about the potential for consolidating smaller DB schemes to help deliver economies of scale, meaning lower costs per member and more effective investment performance.

The deadline for comments on the paper is this month and it remains to be seen how the issues discussed will be developed in light of the snap general election scheduled for 8 June.

5. PPF long service compensation cap comes into force

The Pension Protection Fund (Modification) (Amendment) Regulations 2017 came into force on 6 April 2017 and will increase the standard PPF compensation cap by 3% for each year of a member's pensionable service in excess of 20 years, subject to a maximum of double the standard cap.

The long service cap will also apply to individuals who are already receiving capped PPF compensation, who will have their compensation redetermined with the 3% uplift applied to the cap that was originally applied to that person's compensation with effect from 6 April 2017.

One issue flagged in the response to the consultation on the new regulations is the position for schemes which are currently in a PPF assessment period and which do not then subsequently go into the PPF (and are wound-up). For these schemes, the long service cap will not apply. The consultation response reports that several respondents expressed the view this was unfair when compared with the position for members of schemes which do subsequently enter the PPF (and who will benefit from the long service cap). However, the consultation response says this is not a matter which can be dealt with by the regulations (as it would require primary legislation to amend the Pensions Act 2014).

6. New investment guidance for DB schemes

The Pensions Regulator has published new investment guidance for trustees of DB schemes. The guidance sets out practical information, examples of approaches trustees could take and factors for trustees to consider when investing DB scheme assets.

The guidance covers six key areas:

- **Governance**; covering the trustee's role, working with investment advisers, preparing the statement of investment principles and fiduciary management.
- **Investing to fund defined benefits**; covering financial and non-financial factors, sustainability and setting an appropriate investment strategy.
- **Matching DB assets**; covering the purpose and use of matching assets to manage investment risk relative to the scheme liabilities; diversification; governance and liability driven investment.
- **DB growth assets**; covering the use of growth assets to generate investment returns relative to the scheme liabilities; and the use of multi-asset funds.
- **Implementing a DB investment strategy**; covering the consideration of operational risks, the security of scheme assets, asset transitions and liquidity and collateral management.
- **Monitoring DB investments**; covering the need for monitoring investment strategy and investment managers.

7. Regulator takes action over failures to comply with information requests

The Pensions Regulator has taken action in two recent cases concerning a failure to provide information under section 72 of the Pensions Act 2004.

The first case involved a firm of solicitors and its managing partner, who were both ordered to pay a fine, costs and a victim surcharge for failing to provide documents requested by the Regulator without a reasonable excuse. The Regulator reported that the failure was so serious it merited criminal prosecution. The firm had failed to provide the requested documents despite several attempts by the Regulator over a nine month period, which culminated in the Regulator searching and seizing the documents.

The second case involved the head of a charity who had failed to provide the requested documents despite being pursued for them over an 18 month period.

The Regulator has said that these are examples of how it will use its powers to take action against individuals who hamper its investigations into the management of pension schemes: "*Refusing to comply with a legal request from The Pensions Regulator will not be tolerated*."

8. DWP consultations

1. Reforms to employer debt regime

The Department for Work and Pensions **(DWP)** has launched a new consultation on regulations which would amend the employer debt regime for multi-employer schemes.

The consultation has stemmed from appeals by the industry to reform the employer debt regime for non-associated multi-employer DB schemes on the basis that non-associated employers need more options to help manage section 75 debts that arise on an employment-cessation event (**ECE**) because they are less likely to be able to take advantage of the options currently available.

However, the consultation is proposing amendments which would apply to all multi-employer DB schemes (not just ones with non-associated employers).

The proposal is to allow employers on an ECE to defer payment of the section 75 debt and continue to remain on the hook as a statutory employer (a '**deferred debt arrangement**' – with the employer to become a '**deferred employer**'). This would be subject to trustee consent and the funding test being met, as well as various other requirements.

The regulations as drafted would though give trustees a wide power to subsequently terminate the deferred debt arrangement if reasonably satisfied that the deferred employer has failed to comply with its obligations under the scheme funding regime; or its covenant to the scheme is likely to weaken in "any other way" in the following 12 months. Although the consultation suggests this power would rarely be used in practice, it is broadly drafted and may well put off employers using this route if the regulations are implemented as drafted.

The consultation runs until 18 May.

2. Early exit charges cap and ban on member-borne commission

The DWP is consulting on regulations to: (i) extend the existing ban on member-borne commission; and (ii) introduce a cap on early exit charges in occupational schemes.

Ban on member-borne commission

- There is already in force a ban on member-borne commission for new commission arrangements entered into on or after 6 April 2016. The current consultation is looking to extend this ban to cover agreements entered into before that date.
- The ban will continue to apply only to '**specified schemes**' (broadly, an occupational scheme which provides money purchase benefits (even if only additional voluntary contributions (**AVCs**)) and which is used for auto-enrolment purposes).
- The ban is designed to prevent service providers from imposing a charge on members to recover the cost of commission paid to advisers.
- The draft regulations provide that, where the ban applies, it will override any term of a relevant contract to the extent that the term conflicts with it.

Early exit charges cap

- The intention is to mirror the Financial Conduct Authority's rules on capping early exit charges which apply to members of personal pension schemes (and came into force on 31 March 2017).
- The regulations will impose a cap on early exit charges in occupational schemes with effect from 1 October 2017.
- 'Early exit charges' are charges imposed on a member who has reached normal minimum pension age and is looking to take, convert or transfer their benefits, where the charges are only imposed/imposed to that extent because the member is doing this early (i.e. before normal pension age).
- The cap will apply only to 'relevant schemes' (broadly, an occupational scheme which provides money purchase benefits (even if only AVCs)).
- The regulations will cap early exit charges at 1% for members who joined the scheme before 1 October 2017 (or such lower amount as was provided for under the scheme rules – if there is no provision under the rules, then no charges can be applied); and will operate as a complete ban on early exit charges for members who join a scheme on or after 1 October 2017.

3. Response to GMP equalisation consultation

The DWP published a response to its consultation on the equalisation of Guaranteed Minimum Pensions (**GMPs**) in March.

The consultation sought views on a new method for equalising GMPs 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 (comparing the value of the future expected cash flows), with the greater of the two converted into an ordinary scheme benefit under the existing GMP conversion legislation (to which some changes were being suggested for the purposes of simplification). This would be carried out on an individual member basis.

The consultation had asked for views on whether this is the best approach and what, if any, other methods should be considered.

In its response, the DWP says there was 'broad agreement' that the proposed method is an improvement on previous proposals put forward in 2012, but that questions were raised, in particular regarding the requirement to equalise at all (particularly in light of the Brexit vote); and recent legal action being taken on equalisation issues by a Lloyds Bank trade union.

In terms of the legality of the proposed method, the DWP acknowledges the industry wants assurance that the method would be a legally permissible way of equalising GMPs. In response, the DWP reiterates its message from the consultation paper, saying that this is not the only means by which schemes can equalise and that the Government is not placing an obligation on schemes to use this method. The DWP says it is for scheme trustees to decide what, if any action, is needed for their scheme to provide equal pension benefits and that while the Government believes the method meets the equalisation obligation, this is not a "*definitive statement of how equalisation should be effected*".

The DWP has said it will be taking all comments away and discussing them further. As soon as it is in a position to set out a more definite timeline, it will notify interested parties in the pensions industry.

The response itself does not therefore take the industry much further forward on the GMP equalisation issue and schemes are unlikely to wish to start taking action off the back of this response.

9. Case law update

1. Another High Court case on RPI/CPI

The High Court has handed down judgment in another case concerning a potential switch from using the Retail Prices Index (**RPI**) to the Consumer Prices Index (**CPI**) for the purposes of calculating deferred revaluation and pension increases.

In the case of ***Thales***[1] the scheme rules required a switch of index if RPI is no long published or "*its compilation is materially changed*"; in which case the employer and trustees should determine the "*nearest alternative index*" to be applied. Another set of rules was concerned with whether RPI has been "*otherwise altered*".

The High Court decided that a change to the housing cost element of RPI (a move from using the House Prices Index (**HPI**) to using the UK HPI in 2017) was not a routine change and meant the compilation of RPI had been materially changed. However, RPI (with its materially changed compilation) remained the nearest alternative index. (The decision about RPI having been "otherwise altered" was on the same lines).

The scheme rules did not therefore permit a switch from RPI to CPI.

Like previous cases on the issue, the outcome in this case was very much dependent on its specific facts and the precise wording in the scheme rules. However, it does provide some colour as to what view the courts take on the compilation / components of the RPI and where these will be determined to be materially changed, which will be of use to other schemes which incorporate similar elements in the wording of their rules.

2. More case law on discrimination issues

In a recent case[2] concerning the Firefighters' Pension Scheme 2015, an employment tribunal has found that age-related provisions in the rules were not discriminatory as they had been objectively justified.

The provisions under scrutiny allowed members who were within 10 years of normal pension age to remain active members of the old (more generous) Firefighters' scheme. Members more than 14 years away from normal pension age had to join the new (less generous) scheme and members between 10 and 14 years from NPA had their benefits tapered.

The tribunal decided that although the provisions amounted to prima facie direct age discrimination, they were objectively justified as a proportionate means of achieving legitimate aims, which included:

- to protect those closest to pension age from the effects of pension reform (who would have least time to rearrange their affairs before retirement);
- to take account of the greater legitimate expectation that those closer to retirement would have that their pension entitlements would not change significantly;
- to have a tapering arrangement so as to prevent a cliff edge; and
- to achieve consistency across the public sector.

The decision is in direct contrast to an earlier tribunal decision which looked at similar provisions in the Judicial Pension Scheme (as reported on in our February edition of the UK: Pensions Update). In this case, the legitimate aim put forward by the Government was to protect those closest to retirement from the financial effects of pension reform, but the tribunal rejected this; ruling that the provisions were discriminatory and the Government had failed to objectively justify them.

In the Firefighters case, the tribunal referred to this earlier case; simply stating that it was not bound by the judgment and it was not within its purview to consider that decision. The tribunal said it had to decide the Firefighters case on the basis of the evidence and submissions heard and in those circumstances it had disregarded the decision in the earlier case.

It is understood the Firefighters' trade union is considering appealing the decision, and that the Government has also sought to appeal the decision concerning the provisions of the Judicial Pension Scheme. It is hoped the outcome of any appeals will provide clarity in this area.

[1] ***Thales UK Ltd v Thales Pension Trustees Ltd and others [2017] EWHC 666 (CH).***

[2] ***Sargeant and others v London Fire and Emergency Planning Authority and others ET/2202235/15.***

3. IBM Court of Appeal hearing due to commence

In April 2014, the High Court handed down judgment in the case of ***IBM***[3] in which IBM was found to be in breach of its implied duty of good faith and its implied contractual duty of trust and confidence in connection with a number of changes it had made to its DB pension schemes (including the closure of the schemes to future accrual and the freezing of pensionable pay). A separate judgment was subsequently handed down in February 2015 to address what remedies were available to scheme members as a result of IBM's breach.

The case raised a variety of issues and the decision had important implications across the pensions industry for other employers considering making changes to their own DB pension schemes.

In June 2015, IBM was granted permission to appeal aspects of both the April 2014 judgment and the remedies judgment (and the representative beneficiaries were also granted permission to cross-appeal aspects of the April 2014 judgment). The appeal has been long-awaited by the pensions industry and is now scheduled to be heard in the Court of Appeal; starting this week. The hearing is currently listed to last for 9 days and it is likely the judgment will not be handed down until sometime after this.

10. VAT – where are we now?

As those in the pensions industry will be well aware, HMRC published guidance in 2014 and 2015 for DB schemes making clear that the existing treatment for VAT recovery on pension scheme management costs (as outlined in VAT Notice 700/17) was no longer appropriate as a result of HMRC's interpretation of developing European case law in this area.

Various alternative options for the treatment of VAT on services to DB pension schemes were being considered by HMRC and while the details were being worked out, a transitional period was declared; allowing the VAT treatment outlined in Notice 700/17 to continue to be applied until 31 December 2016 (originally extended from 31 December 2015).

Last September, HMRC issued Brief 14/2016 extending the transitional period by a further 12 months to 31 December 2017, meaning that VAT can continue to be accounted for on the basis set out in VAT Notice 700/17 until then.

So, as 2017 progresses, where are we now?

HMRC is yet to publish finalised guidance regarding the alternative options for VAT recovery on services to DB schemes. The industry is expecting this guidance at any moment and it is anticipated that it will endorse the 'back-to-back' supply of services route (where the trustees enter into an agreement to supply the service of administering the scheme to the employer in exchange for a fee); although a number of issues with this route (and the alternative routes) still remain outstanding.

In terms of what action schemes and employers should be taking now, it would make sense to wait for this further guidance from HMRC before taking action. HMRC has also indicated that it is considering a further extension of the transitional period beyond the end of this year (in light of Brexit).

However, for schemes with triennial valuations approaching, it may be worth taking the opportunity to check what the schedule of contributions says about administration costs and whether this needs amending. For example, it may be prudent to clarify in the schedule of contributions that a separately identifiable proportion of the employer contributions paid is to be considered a fee to the trustees for providing the administration services. This could then be reflected in a supply of services agreement if the employer and trustees later choose to go down this route.

11. Pensions clearing exemption extended again

The European Market Infrastructure Regulation (648/2012), which came into force in August 2012, requires over-the-counter derivatives to be cleared.

However, certain pension scheme arrangements benefit from a transitional exemption which means they do not have to comply with the clearing obligation.

The exemption was due to expire this August, but has recently been extended once more and will now run until 16 August 2018.

[3] ***IBM UK Holdings Limited and another v Dalgleish and others [2014] EWHC 980 (Ch).***