

Pensions

November 2011

Welcome

Welcome to Pensions, our bimonthly update keeping you informed of developments in pensions law.

To find out more about how we can help you with your occupational pension scheme, please email richard.knight@burgess-salmon.com or call him on 0117 939 2259.

Legal

A new definition of “money purchase (or DC) benefits” and the detail of the promised exceptions from CPI are among the changes made by the Pensions Act 2011, recently passed by Parliament.

There are also amendments in other significant areas. Two come into effect early next year, but otherwise no dates have yet been set for any of the changes to come into force.

- **Money purchase (or DC) benefits:** the amended definition is the result of the Supreme Court’s decision (in *Bridge v Yates*) that a DC scheme is nonetheless “money purchase” where it guarantees a minimum investment return or pays the annuity itself. In abbreviated form, the new core definition is:

“benefits the rate or amount of which is calculated by reference to a payment or payments made by the member or by any other person in respect of the member *and its rate or amount is calculated solely by reference to assets which (because of the nature of the calculation) must necessarily suffice for the purposes of its provision.*”

The new words are in italics. They aim to ensure that a scheme can only be money purchase where there is no risk of a deficit.

Schemes that cease to be money purchase as a result of the new definition will be subject to all the legislation that applies to DB schemes, like scheme funding, the s.75 employer debt, and the PPF levy and protection.

The new definition will be backdated to 1 January 1997 (sic). The government has chosen this date so that, broadly, there is consistent treatment for all schemes that have wound up since the Pensions Act 1995 came into force, and in particular for all schemes that have qualified for FAS protection.

The definition will be accompanied by what are likely to be elaborate transitional regulations that, among other things, will mean that decisions made in relation to schemes long since wound



up need not be re-opened. The definition and the regulations will need to be brought into force together as a package.

The new definition has been put together fairly hastily and the government has flagged that it might need further adjustment in the transitional regulations.

There will be a public consultation on a draft of the regulations. It looks unlikely the package of measures will be ready to come into force until late winter, or perhaps next April.

With such a long retrospective period, the transitional regime needs to be carefully thought through. But even if it is, some schemes may face what they regard as harsh outcomes.

- **State pension age:** the Act gives effect to changes already announced. For women, SPA will be equalised at 65 by November 2018. For women and men, SPA will be 66 by October 2020. The timetable for increases beyond 66 is under consideration. Schemes that provide bridging pensions will be paying them for longer.

This change comes into effect in early January next year.

- **Auto-enrolment:** the Act makes a number of the changes the government announced following the review it carried out when it came into power. Others will be dealt with in regulations.

The changes in the Act include confirming the earnings threshold for auto-enrolment at £7,475 (in current terms), the option for the employer to

postpone auto-enrolment for up to three months, and some more flexibility over the choice of scheme that can be used.

This takes the legislation a step closer to readiness. Still to come is a substantial batch of regulations filling in the finer details. A consultation on these closed in October.

- **CPI:** the headline change to CPI for revaluation and pension increases did not require amendments to the legislation. But changes were needed to stop statutory CPI acting as an underpin in schemes that are hard wired to RPI (which would force the scheme to use the higher of the two indices). We now have these amendments.

On revaluation, there is no underpin where the scheme's rules require it to follow the statutory system, with the exception that it uses RPI rather than CPI. So, for example, the scheme has to measure inflation over the statutory reference period (the 12 months to the end of September).

On increases, there is no underpin where, since the start of 2011,

the scheme rules require increases that reflect (capped) RPI measured over a reference period chosen by the scheme.

In addition, the existing exception that allows a scheme to pay increases in line with the statutory system but using its own reference period for inflation remains available.

As a side-light, a legal challenge is under way to the switch to CPI in public sector schemes. Depending on the outcome, this could have implications for private sector schemes where some of the arguments against the change-over are equally applicable.

- **Refunds of surplus:** this is the awkward point about trustees needing to pass a resolution to preserve an existing power to pay refunds. The deadline of April this year was suspended when the DWP accepted that the original legislation was much too widely drafted. Now there is a much more user-friendly provision, and a long deadline of 2016 to pass a resolution.

This change comes into effect in early January next year.

Regulatory

DC trustees urged on

DC is not DB, and it needs different governance to manage its risks, says the Regulator (TPR).

Trustees of DC schemes will find useful, big-picture guidance on their role in TPR's recent statement*.

Prompted by survey evidence of weaknesses in the governance of a significant proportion of DC schemes, TPR has produced a simple guide to the differences between DC and DB and the ways DC trustees should conduct themselves.

In the past, DC has often been seen as a simple form of provision that needs little attention. Trustees and employers have been unengaged according to the survey evidence. But with the decline of DB and the start of auto-enrolment next year TPR is increasingly keen for DC schemes to raise their game.

The behaviour TPR wants to see from trustees includes:

- DC specific knowledge in their TKU;
- procedures that address conflicts of interest like that between an individual's roles as trustee and as employee (or director) of the sponsor;
- exercise independent control over functions delegated to service providers, including where functions like administration and investment are provided by related parties;
- carefully examine charging structures that are often opaque and can disfavour certain classes of member e.g. deferreds. TPR does not regard charges that disadvantage certain members as acceptable;

- formally and regularly review the appropriateness of investment funds available to members, including any default fund. Review of the default fund must take account of the DWP's guidance**;
- invest prudently, and mainly in assets that are managed by entities registered with the Financial Services Authority (or equivalent regulator). Trustees must be able to demonstrate why any unregulated investment options are appropriate and must communicate the risks clearly to members. They must establish what compensation arrangements apply if a provider defaults e.g. the Financial Services Compensation Scheme;
- diligent administration all round e.g. devoting regular and adequate time to the scheme's governance, identifying and addressing risks through a risk register, and high quality record-keeping;
- stringent procedures to collect and invest contributions on time, and ensuring members understand that their pension depends on the amount paid in for them and investment performance.

* "The role of trustees in DC schemes" October 2011. www.thepensionsregulator.gov.uk/docs/role-of-trustees-in-dc-schemes-statement-oct-2011.pdf

** Guidance for offering a default option for DC automatic enrolment pension schemes. See www.dwp.gov.uk/docs/def-opt-guid.pdf

Risky hybrids

Hybrid schemes can be complicated. With more members in prospect in the next few years as auto-enrolment comes in, TPR is concerned that trustees and advisers understand the risks they involve and what can be done to mitigate them.

TPR's recent statement* on the risks draws on a survey of 150 hybrid schemes and has checklists to help those involved in such schemes respond appropriately.

The term "hybrid" does not have a single meaning. It is used, for example, to refer to schemes:

"Trustees of DC schemes will find useful, big-picture guidance on their role in TPR's recent statement."

- with DB and DC sections that are entirely separate,
- that offer the better of a DB and a DC benefit,
- that are DC but are contracted out on a DB basis and
- that are DB but have a DC top up.

The complexity of some hybrids was highlighted in the recent Supreme Court decision that had to explore whether certain benefits were “money purchase(or DC)” or DB. The decision led to the new definition in the Pensions Act redrawing the line between the two types of benefit.

Risks

TPR lists these risks.

- Lack of governance. The survey showed that most trustees spend less than a quarter of their time on the DC element of their scheme.
- Unclear and incorrect communications to members. The mixed nature of the benefits in many hybrid schemes meant that trustees often found it difficult to give members the clear and accurate information they needed to understand and make decisions about their entitlement. Statutory information requirements were often neglected.
- Benefits and funding levels can be incorrectly calculated where DB and DC assets are not

separately identifiable. Half the sample used the same bank account for both forms of benefit and many could not identify which amounts belonged to which members. There was poor understanding of what benefits had PPF protection and the priority order for paying benefits on a winding up.

- Inappropriate investment strategies. A third of schemes used the same investment strategy for DB and DC benefits even though the employer bore the investment risk in the one case and the member in the other. Two thirds of schemes used the same investment adviser for both elements of the scheme.
- Failure to offer an open market option at retirement as required by legislation.

Scheme returns now ask for more information about hybrids. This is to help TPR hone its approach to their regulation.

The statement ends with brief checklists for trustees, administrators and advisers.

* “Understanding and managing your hybrid scheme” October 2011 www.thepensionsregulator.gov.uk/docs/understanding-and-managing-your-hybrid-scheme-statement-oct-2011.pdf

In the office



We welcome Nicky Chatten back after her maternity leave.

One Glass Wharf
Bristol BS2 0ZX
Tel: +44 (0) 117 939 2000
Fax: +44 (0) 117 902 4400

Chancery Exchange
10 Furnival Street
London EC4A 1AB
Tel: +44 (0)20 7685 1200
Fax: +44 (0)20 7685 1266

www.burges-salmon.com

This newsletter gives general information only and is not intended to be an exhaustive statement of the law. Although we have taken care over the information, you should not rely on it as legal advice. We do not accept any liability to anyone who does rely on its content.

© Burges Salmon LLP 2011.
All rights reserved.

Your details are processed and kept securely in accordance with the Data Protection Act 1998. We may use your personal information to send information to you about our products and services, newsletters and legal updates; to invite you to our training seminars and other events; and for analysis including generation of marketing reports. To help us keep our database up to date, please let us know if your contact details change or if you do not want to receive any further marketing material by contacting marketing@burges-salmon.com

Burges Salmon LLP is a Limited Liability Partnership registered in England and Wales (LLP number OC307212) and is authorised and regulated by the Solicitors Regulation Authority.

A list of members, all of whom are solicitors, may be inspected at our registered office: One Glass Wharf, Bristol BS2 0ZX.

Policy

ETVs

Pensions Minister Steve Webb has given the industry a year to improve its practices around enhanced transfer value (ETV) exercises. Or the government will legislate.

Speaking at the NAPF annual conference he said the DWP will work with the industry to produce a code of practice on acceptable standards.

Transparency and communication are the main concerns. For an ETV to be acceptable, members must be made fully aware of what they would be giving up and whether the swap is ultimately in their best interests.

ETVs are derisking exercises that can take various forms. For example, the offer of an enhanced transfer value if a member agrees to switch to an employer’s DC scheme. Or a higher base pension in return for surrendering non-statutory pension increases.

The code of practice is likely to build on the guidance TPR has already issued (most recently in December 2010).



Short service refunds

Steve Webb is reported to have told the CBI’s pensions conference there is a firm plan to phase out short service refunds. A consultation will start later this year on how small pension accounts might be handled in future. This too is part of the government’s preparation for auto-enrolment.

Visit our website at www.burges-salmon.com