



Pensions news for employers

Welcome to the **summer edition** of pensions news for employers.
This newsletter covers a number of topical issues of which companies should be aware.

Budget 2014 – DC flexibility raises significant issues for DB schemes

The budget announcement on 19 March 2014 included a number of measures to improve the flexibility of defined contribution (DC) pensions, with important knock-on effects for defined benefit (DB) arrangements.

Currently the key questions for employers to have in mind are:

1. Will DB to DC transfers be banned (possibly with some form of retrospective effect back to 19 March 2014)?
2. How can sponsors of DB schemes make use of the new rules in terms of future benefit design and the management of past liabilities?



The government's stated reason for considering a ban on DB to DC transfers is to protect the role of DB schemes as investors in gilts and areas supporting long-term economic growth, such as infrastructure projects. The government will explore alternatives to an outright ban, such as allowing transfers subject to trustee consent, or preventing access to the new DC flexibility for transferred funds.

Any employer wanting to undertake a transfer exercise before the government announces its decision, which could be as early as July, should only consider doing so on a targeted basis, i.e. selecting a small number of high value liabilities. Otherwise, Independent Financial Advisers (IFAs) are likely to refuse to take part in the exercise, or advise against transferring in all cases due to the uncertainty of possible retrospective implications.

In terms of future benefit design, employers cannot make any decisions until the government's decision on DB to DC transfers is known. If they are banned, then many staff might find DC provision more attractive than DB going forward, which could result in significant savings for the employer.

As a half-way house, a cash balance plan could be offered to effectively provide staff with guaranteed investment returns up to retirement, but then have access to the DC flexibility at that point (as cash balance plans are classified as DC for this purpose).

If DB to DC transfers are not banned, then transferring to a drawdown arrangement at the point of retirement could become a very popular option. This transfers post-retirement risks (e.g. investment returns, longevity, inflation) from the scheme/employer to the individual. It is already possible to put such an option in place, often referred to as a 'Retirement Transfer Option', as many schemes have done.

A clever approach is required to enable members to retire now but still have access to the new DC flexibility when it becomes available (for example, utilising capped drawdown arrangements, or the one-year annuity now offered by some insurers). From April 2015, though, it would be a simple case of transferring directly to any suitable DC arrangement.

Budget 2014 – DC flexibility raises significant issues for DB schemes continued...

The government also announced some relaxations of the limits on lump sums that can be paid to extinguish small entitlements. This improves the opportunities for employers to remove small liabilities from their schemes alongside other exercises such as scheme mergers, or any situation where a large number of scheme members are being presented with options in relation to their benefits. Some schemes perform such 'sweep ups' on a regular basis and the relaxation of limits will also improve the effectiveness of this approach. In particular:

- Where the combined value of all of an individual's approved arrangements is less than a certain limit, these can be taken as a taxable 'trivial commutation lump sum'. The trivial commutation limit has been increased from £18,000 to £30,000.
- If the value of an individual pension arrangement is less than a certain limit at retirement (i.e. ignoring the value of any other pension savings or entitlements the member may have elsewhere) then it can be taken as a taxable 'de minimis' lump sum. The limit has been increased from £2,000 to £10,000.
- Employers should note that the government proposes to increase the minimum pension age from 55 to 57 with effect from 2028. It will then rise in line with the State Pension Age (SPA) so that it is always 10 years below SPA. The government is also asking respondents whether they should legislate to increase the minimum pension age further, for example so that it is five years below SPA.

Barnett Waddingham comment

There are a number of areas for careful consideration by employers with DB schemes in relation to the budget announcements:

- With the increased limits for trivial commutation, employers should consider running a trivial commutation exercise to remove liabilities from the scheme.
- Employers should also consider enhanced transfer value exercises targeted towards small groups of large liability members who are nearing retirement age.
- Options to transfer out at the point of retirement remain sound, but employers should ensure that members are aware of the changes announced at the budget and ideally arrange for them to be provided with information on how to integrate the option with access to DC flexibility (to avoid take-up of the option being harmed through members' uncertainty). Also, for schemes that do not yet offer a retirement transfer option as standard, employers should consider implementing this, as it may be an even more popular option from next year.
- The government's response to the consultation will be a trigger for further action, especially regarding DB to DC transfers.

Fixed Protection 2014 and Individual Protection 2014

From 6 April 2014, the lifetime allowance (LTA) reduced from £1.5m to £1.25m and the annual allowance (AA) reduced from £50,000 to £40,000. The government introduced two types of protection for individuals who were affected by the changes:

- Fixed Protection 2014 (FP14): Under FP14, savers will retain an LTA of £1.5m, provided they make no new pension savings after 5 April 2014. The deadline for registering for FP14 was 5 April 2014.
- Individual Protection 2014 (IP14): Under IP14, savers will have a 'personalised' LTA based on the value of their savings at 5 April 2014 (minimum of £1.25m and up to a maximum of £1.5m). Individuals could continue to make contributions without paying an LTA charge on savings up to their personalised LTA, but would pay LTA charges on additional savings. Individuals have three years from 6 April 2014 to apply for IP14.

Individuals who obtained FP14 may also apply for IP14 if they wish. The fixed protection will take precedence, with protection reverting back to IP14 if fixed protection is lost. Individuals with Primary Protection (effective from 6 April 2006) will not be able to apply for IP14, but individuals with Enhanced Protection (also effective from 6 April 2006) will be able to apply for IP14, provided they do not also hold Primary Protection. Further information and case studies can be found in our most recent [commentary](#).

Bhargav Buddhdev, Head of Executive Pensions at Barnett Waddingham, will be commenting on the LTA and AA changes during our Health and Wealth Seminars in the autumn. Further details on these seminars can be found our [events page](#) of the website.

PPF consults on levy changes, including new insolvency risk model

The PPF published a consultation on 29 May 2014 setting out its plans for the next three levy years.

Alongside other proposals, the PPF has confirmed that it is intending to use a PPF-specific bespoke model, rather than Experian's Commercial Delphi model, for the calculation of future PPF levies. This new model, which was developed in partnership with Experian, is based solely on 'the sub-population of sponsors of PPF-eligible pension schemes', and only reflects the insolvency experience of sponsors within that population.

The main features of the model are as follows:

- different scorecards for different types of employers where the size and legal structure of the entity (i.e. whether it is part of a group, a stand-alone business or a not-for-profit organisation) will be key determinants in assessing an entity's risk of insolvency;
- a greater focus on the entity's financial fundamentals rather than some of the more unusual 'non-financial' indicators used in the D&B failure score system;
- more emphasis on user experience, e.g. free-to-use web portals - allowing users to check information held on sponsors and monitor their insolvency probabilities.



Due to the delays in releasing the new model, only insolvency ratings from 31 October 2014 and onwards will be considered in the calculation of the 2015/16 PPF levy, addressing some of the concerns around the timing of the consultation and the time companies would have to analyse and check their new insolvency ratings. This will result in a shorter averaging period for the 2015/16 levy year, i.e. 6 months instead of 12 months.

Companies, particularly those with a complicated group structure, should act on the PPF's advice and make sure that the information held on the Regulator's Exchange system, as well as on Experian's online web platform, is correct and up-to-date. The impact of the change in model on companies' PPF levies could be substantial, so companies should ensure that they understand their new insolvency risk rating as soon as possible.

As well as the new insolvency risk model, the PPF have confirmed that they are intending to bring in changes in relation to Type A guarantees, Asset Backed Contribution ('ABC') arrangements and the treatment of 'last man standing' schemes in the levy calculation. A brief summary of these proposals is set out below:

Type A contingent assets - Trustees will now be required to certify a fixed monetary sum, and guarantors' PPF insolvency probability will be adjusted to reflect the increased level of gearing on their balance sheet.

ABCs - As a result of the PPF's concerns about the true risk-reducing properties of a number of ABCs, only ABCs with underlying UK property assets can now be recognised (although the PPF may consider other assets, such as cash or securities). The value of an ABC will be removed from the Scheme's s179 asset value, and will now need to be recognised through the submission of a voluntary certificate to the PPF. Further changes have been proposed.

Last man standing schemes - The PPF have proposed that the discount given to 'last man standing' schemes in the levy calculation should be adjusted to reflect the actual spread of risk between sponsoring employers. The discount is currently 10%, but in future will be up to a maximum of 10%, depending on the spread of the membership between the participating employers.

The consultation closes on 9 July 2014.

Barnett Waddingham comment

The PPF appears to be addressing the major concerns raised by its stakeholders; a number of these issues were highlighted in Barnett Waddingham's PPF Levy Survey 2014 (results of which were passed on to the PPF).

Whilst some of the factors considered by the old D&B model were statistically good early indicators of insolvency, they often caused unwarranted volatility. There were also too many examples of D&B factors unfairly penalising companies, often resulting in very large financial consequences. The new approach should reduce the potential for scores to be manipulated by levy payers, as the majority of the variables are based purely on financials. This can only make the system more credible.

However, these changes will, at least initially, result in some substantial differences in company levies. It is therefore important that companies understand these changes and, in particular, the impact that these changes are likely to have on their individual circumstances.





End of contracting out

The end of 'contracting out' for defined benefit (DB) arrangements that are still open to accrual will bring some short-term complications to those that sponsor them.

Employers will need to act quickly if they wish to mitigate the associated increase in National Insurance (NI) costs from April 2016.

A statutory override will enable employers to make suitable benefit adjustments to cancel out the additional NI without the need for trustee consent or member consultation.

The government announced more recently (following consultation) that the statutory override will not apply in relation to Protected Persons. These are individuals who were employed within previously nationalised industries and are subject to legislation that prevents employers from making changes to the pension benefits offered to them.

Barnett Waddingham comment

Our commentary on the [single-tier state pension](#) provides more detail, including information about our 'Impact Modeller' which determines the extra costs than an employer faces, based on staff payroll information, and models the impact of changes in accrual rate or member contributions.

The government's decision in relation to Protected Persons means that any employer wishing to achieve a cost neutral staff cost before and after the end of contracting out will probably need to negotiate a salary adjustment with relevant staff, rather than applying the same pension adjustment as for other members. This increases administrative burden by adding an extra tranche of benefit accrual, as well as the time and cost of the necessary negotiations.

Although only a small proportion of private sector pension scheme members are Protected Persons (around 4%, or 60,000 people) they are concentrated within certain industries and so some employers will have a high proportion of Protected Persons. For those employers, the issue will further increase the divide between their staff who are protected and those who are not.

Equality: Civil partnerships and same-sex marriages

Under the Civil Partnership Act 2004, occupational pension schemes must treat civil partners in the same way as married couples.

In particular, spouses' benefits that would be payable on the death of a member must also be payable to civil partners. At present, schemes are only legally obliged to do this in respect of post 1988 GMP (Guaranteed Minimum Pension) and non-GMP benefits earned after 5 December 2005 (the date the Civil Partnership Act came into force) although many schemes opted to extend the rights to civil partners for all service. A member of the Innospec Limited pension scheme took his employer to an Employment Tribunal to argue that limiting his civil partner's benefits to post-2005 service was discriminatory.

Although the tribunal originally agreed with the member, the decision was recently overturned by the Employment Appeal Tribunal. Since 13 March 2014, same-sex marriages have been legal in England and Wales. Trustees and employers will need to consider whether they are required to extend the rights of same-sex spouses to benefits earned before 5 December 2005 and obtain legal advice where appropriate.

There may be yet further developments in this area. In particular, the Equality Act 2010 is currently under review by the government and a report is due to be published by July 2014.

Employer duties of good faith (IBM v Dalglish)

In a landmark case, IBM v Dalglish, the High Court has held that IBM breached its duties to members of its UK pension schemes in the way it implemented a restructuring of their pension arrangements.

In 2006 IBM made a number of changes to members' benefits that included giving members in the defined benefit (DB) sections of the schemes the option to cease accrual and move to a defined contribution (DC) scheme with enhanced employer contributions.

The alternative was to accept that only a proportion of future salary increases would be pensionable within the DB schemes. This followed other changes in 2005 that had required members to increase their contribution rate.

From 2009 onwards IBM made further changes to the schemes through Project Waltz:

- pensionable salaries were frozen;
- the DB sections were later closed to future accrual; and
- a new, less generous, early retirement policy was implemented.

A case was brought against IBM by the members and trustee that, from the 2006 changes, members' expectations had been that the schemes would remain open to future accrual for the foreseeable future. Therefore the Project Waltz changes breached the duties owed to the scheme beneficiaries.

The case looked at both the 'contractual' duties (implied contractual obligations of trust and confidence) and 'Imperial' duties (duty of good faith) of IBM to their employees.

Mr Justice Warren found that IBM was in breach of both its contractual and imperial duties by proposing the changes under Project Waltz. He also held that IBM had breached its contractual duty in the way it conducted the Project Waltz consultation with members, which he said was neither open nor transparent.

Barnett Waddingham comment

The problem here was not the benefit changes that were made, which are indeed commonplace now, but the way in which they were implemented and the lack of transparency in consultations.

A further hearing will be required to establish remedies (unless the decision is successfully appealed). The key message for employers is to take great care over any such benefit changes and ensure that member communications during consultation are open and transparent.

European Commission publishes IORP II proposals

The European Commission has published a draft revision of the Institutions for Occupational Retirement Provision (IORP) Directive (IORP II) which aims to:

- improve pension scheme governance and introduce an independent audit system to identify, monitor, manage and report risk on a continuous basis;
- remove certain restrictions on cross-border activity to promote long-term cross-border investment in asset classes such as infrastructure;
- introduce a fit and proper test for people running schemes; and
- introduce standardised two-page annual benefit statements across Europe.

As expected, the updated directive does not impose a Europe-wide solvency regime (although this is still being evaluated). Despite earlier reports to the contrary, the revisions do not relax existing cross-border funding requirements.

The new governance and disclosure requirements could prove to be significant, and published cost estimates are:

- a one-off adjustment cost estimated at around €22 per member, plus
- recurring additional costs estimated between €0.27 and €0.80 per member per year.

The directive will have to be approved by the EU Council and the European Parliament and is expected to come into force by 31 December 2016.

Barnett Waddingham comment

With solvency-based funding requirements currently out of the picture, the key issue for the vast majority of employers is whether the scheme governance requirements will be substantially different from current practice. There is little that can be done to prepare until further detail becomes available.





VAT on pension fund management costs

Two recent rulings by the Court of Justice of the European Union (CJEU) could mean that some schemes are able to reclaim VAT paid on investment manager fees in certain circumstances:

- Defined benefit (DB) schemes: HM Revenue & Customs (HMRC) has issued a [briefing for DB schemes](#), setting out its updated policy on the recovery of VAT on pensions investment management costs following a CJEU ruling last summer. As a result of the briefing, there are circumstances where employers may be able to reclaim input tax in relation to pension funds where they could not before. However, in practice, such circumstances are expected to be very limited.
- Defined contribution (DC) Schemes: A further preliminary judgement by the CJEU could allow wider recovery of VAT on management costs for some DC pension schemes. DC pension schemes investing through insurance wrappers are not likely to be affected by the ruling since there is currently already an exemption for VAT on management costs in these cases. However, DC scheme trustees should monitor the situation as the case returns to the Danish national courts. It is not clear when (if at all) HMRC will provide clarification of the UK's approach.

Employers may wish to obtain specialist taxation advice and review schedules of contributions to maximise the level of VAT recovery in future.

TPR research on scheme expenses

The Pensions Regulator (TPR) has published their findings on how defined benefit (DB) schemes of different sizes are affected by administration and other running costs. The research revealed:

- almost 25% of trustees of private sector DB schemes do not know how much they are paying in investment charges;
- small DB schemes pay on average nearly four times as much as large schemes per member in running costs (£1054 p.a. for smaller schemes compared to £281 for large schemes); and
- scheme administration represents the greatest proportion of running costs – around 37% on average.



Alongside this research, TPR has developed a charges checklist and web tool which allows trustees and sponsoring employers to compare the cost of their scheme with other typical schemes of similar size.

The web tool is extremely easy to use – simply select the size of your scheme and the results are displayed. The tool gives the lowest, highest and average cost per member from the schemes surveyed and provides a breakdown of the average DB running costs for schemes of each size. The tool also shows a graph comparing the running costs of schemes of different sizes.

Barnett Waddingham comment

Whilst trustee knowledge of the scheme expenses they are paying is not great, sponsoring employers are in an even more difficult position, as they often have no hands-on involvement in the scheme expenses, despite being ultimately responsible for paying them.

For schemes open to accrual, an allowance for expenses may be wrapped up in the ongoing contribution rate. For schemes closed to accrual or with relatively few active members, the employer may simply pay a fixed sum in relation to expenses, which might only be reviewed every few years at the most.

It is important that employers engage with trustees over scheme expenses – not necessarily to drive them down, but to ensure that decisions being taken on the level of services to procure are consistent with the employer's expectations.

Investment management fees are a key area where employers should take a view and make an explicit decision on the level of management desired (e.g. active versus passive at the most basic level) and the corresponding level of fees to be incurred.



Barnett Waddingham comment

The covenant of the sponsoring employer is now firmly set at the centre of the valuation process. Employers wishing to negotiate with trustees over assumed future investment returns, for example, need to be prepared to demonstrate their ability to mitigate adverse outcomes. If any bolstering of the covenant is required, it could be beneficial to put in place contingent guarantees (e.g. backed by a parent company, or tangible fixed assets of the employer).

The new Code of Practice reflects the evolution of TPR's approach to the regulation of scheme funding over recent years and fits well with the way in which funding already operates for most larger schemes.

The real test will be whether TPR can implement its policies consistently from case to case. Employers should actively engage with the valuation process early on and must have clear objectives for the scheme in mind. For more information, please see our latest note on [valuation services](#).

DB scheme funding

The Pensions Regulator (TPR) published its revised code of practice on pension scheme funding on 10 June 2014, following a consultation that closed in February.

Some significant improvements were made in response to the consultation. It is now clearer where a proportionate approach is expected, and certain points have been clarified to help avoid trustees feeling required to go beyond the level of negotiations with employers that TPR intended. For example, in relation to employers' dividend policies.

The main addition to the code is around the risk management approach and introduces a risk management cycle for identifying and managing risks. TPR also set out its principles of scheme funding, including:

- trustees and employers are expected to work collaboratively 'in an open and transparent manner' to reach solutions that meet the needs of the scheme, and the employer's plans for sustainable growth;
- trustees should seek to integrate management of risks (employer covenant, investment risk and funding risk) and set clear triggers for action;
- where trustees take funding or investment risk, they should be confident that the employer is able to mitigate likely adverse outcomes with appropriate contingency plans; and
- trustees should act proportionately, taking into account their scheme's size, complexity and circumstances.

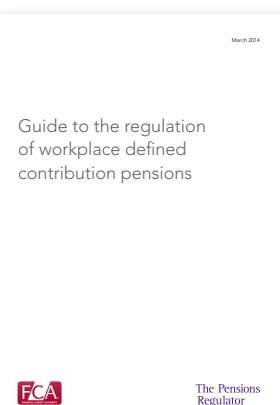
The code was updated in order to reflect TPR's new statutory objective and to re-align the code with TPR's current practices in relation to the regulation of scheme funding. The opportunity was also taken to move some of the more technical aspects of the code to appendices.

The new Code of Practice applies to schemes completing valuations from July 2014, although TPR has confirmed that a pragmatic approach will be taken to the extent to which valuations completed this year are expected to have taken account of the new code.

TPR and FCA regulatory guide

The Pensions Regulator (TPR) and the Financial Conduct Authority (FCA) have jointly launched a [new guide](#) which sets out how they regulate defined contribution (DC) workplace pensions.

The guide outlines each regulator's approach and how they work together to ensure consistency. A series of quality standards for DC schemes, due to be launched by the Department for Work and Pensions, will set minimum requirements for governance, investment fund design and administration to help ensure a good level of protection for members regardless of the type of scheme selected by the employer.





Barnett Waddingham news

A>E website

Barnett Waddingham and Standard Life have teamed up to provide a simple, packaged solution for employers – removing the stress of auto-enrolment and letting you get back to work. The [dedicated website](#) provides guides for both employers and introducers, along with a top-10 list to help you get prepared and full details of the product.

European companies with exposure to UK pension liabilities

Our latest research reports on European companies with exposure to UK pension liabilities cover constituent companies of the German DAX30 and Dutch AEX share indices. They focus on funding, contributions, the impact of pensions on shareholder value, and indirect equity exposure. It is interesting to note that despite having average funding levels substantially above the schemes of FTSE350 companies, the [German](#) and [Dutch](#) owned companies continue to pay significantly higher deficit contributions.

Awards



Barnett Waddingham has been named Pensions Advisor of the Year and Actuarial Advisory Firm of the Year by ACQ magazine at its Global Awards 2014. ACQ is a leading monthly M&A (mergers and acquisitions) magazine with a readership of over 50,000.



We have also been named best actuarial consultant at Pensions Expert's 2014 Pension Investment Provider Awards (PIPA) for the second year in a row. "Pensions Expert is the Financial Times' flagship publication covering the pensions industry with a readership of more than 8,000.

Upcoming events

Scheme funding seminars

Barnett Waddingham will be hosting a series of seminars in July to discuss the new code and other developments relating to funding DB pension schemes:

Amersham - Tuesday 8 July

London - Wednesday 9 July

Leeds - Thursday 10 July

Birmingham - Tuesday 15 July

Health and Wealth seminars

Aligning employee benefits with corporate objectives is paramount for employers and trustees. Our seminars will provide industry insights on how to achieve these objectives with views from our expert speakers Damian Stancombe (Head of Employee Benefits) and Carl Chapman (Head of Wellbeing).

Amersham - 30 September

Liverpool - 2 October

Leeds - 7 October

Cheltenham - 8 October

Further details on these seminars will be on our [events pages](#) of the website.

Corporate Consulting Blog

Our [corporate consulting blog](#)

is a useful source of information and comments on the pensions news that matters most to employers.



Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

@ corporateconsulting@barnett-waddingham.co.uk

☎ 020 7776 2200



3281133 | June 2014

👉 Are you a Finance Director? If so, why not visit www.fdpensions.co.uk to keep up to date with issues that could affect you.

Barnett Waddingham LLP is a body corporate with members to whom we refer as "partners". A list of members can be inspected at the registered office. Barnett Waddingham LLP (OC307678), BW SIPP LLP (OC322417), Barnett Waddingham Investments LLP (OC323081), and Barnett Waddingham Actuaries and Consultants Limited (06498431) are registered in England and Wales with their registered office at Cheapside House, 138 Cheapside, London EC2V 6BW. Barnett Waddingham LLP is authorised and regulated by the Financial Conduct Authority and is licensed by the Institute and Faculty of Actuaries for a range of investment business activities. Barnett Waddingham Investments LLP and BW SIPP LLP are authorised and regulated by the Financial Conduct Authority. Barnett Waddingham Actuaries and Consultants Limited is licensed by the Institute and Faculty of Actuaries in respect of a range of investment business activities.

Amersham | Bromsgrove | Cheltenham | Glasgow | Leeds | Liverpool | London