Sackers

The Quarterly
December 2010

Highlighting significant developments in pensions law, covering key areas such as pensions reform, regulatory developments, new legislation and cases.

The Quarterly December 2010

In this issue

Abbreviations commonly used in the Quarterly:

Alert/News: Sackers Extra publications (available from the Sackers Extra area of our website or your usual contact)

CPI: Consumer Prices Index

DB: Defined benefit

DC: Defined contribution

DWP: Department for Work and Pensions

EU: European Union

NEST: National Employment Savings Trust

PPF: Pension Protection Fund

RPI: Retail Prices Index

TPR: The Pensions Regulator

Pensions Reform

Pensions Tax Relief Restrictions

On 14 October 2010, the Treasury published its final plans for the restriction of tax relief on pensions savings.[1] The new approach represents a significant improvement, both on the previous Government's plans and the Coalition's original proposals. While wholesale scheme re-design may not be needed in many cases, employers will need to identify as soon as possible those individuals with accrual that would regularly take them above the Annual Allowance (AA) and consider possible alternatives.

Key points

Key points arising form the Government's response[2] include:

Annual Allowance significantly reduced

- the reduction of the AA to £50,000 from its current level of £255,000 from the tax year 2011/12 (when the existing anti-forestalling provisions[3] will fall away);
- the lifetime allowance (LTA) will also be reduced – to £1.5m, down from £1.8m – from April 2012 to allow for a transitional period;
- individuals will continue to receive relief at their marginal rate (up to the new AA), not at 40% as proposed in the July consultation;[4] and
- the factor used to measure "deemed contributions" in DB schemes will be increased from 10 to 16 from April 2011.

Individuals who exceed the AA due to one-off spikes in accrual will be able to set-off excess contributions against unused allowance from up to three previous tax years.

Further consultation due

Limited exemptions

There will be an exemption from the new AA for benefits on serious (terminal) ill-health and the Government plans to consult later in the year on a possible exemption for ill-health benefits generally. However, there will be no exemption for benefits payable on redundancy, for individuals claiming enhanced protection, or in the year when benefits come into payment.

The Government will also consult on options to enable tax charges to be met out of an individual's pension.

The Finance Bill 2011 will include provisions to enact the new AA and LTA.

Spending Review

The Spending Review is the Treasury-led process to allocate resources across government departments, setting fixed spending budgets over several years. The 2010 Spending Review covers the four tax years from 2011/12 to 2014/15.

Key points

In his greatly anticipated statement on 20 October 2010, the Chancellor, George Osborne, announced that:

SPA to increase to 66 by 2020

- the planned increase in the State Pension Age (SPA) will be accelerated, reaching 66 for all by 2020. The rise will start in 2018, meaning that SPA for women will go up more quickly than expected;

1 Please see our Alert: "Restricting pensions tax relief: the verdict" dated 14 October 2010

2 http://www.hm-treasury.gov.uk/d/consult_pensionsrelief_discussion.pdf

3 Please see our Alert: "Finance Act 2009: This time it's personal" dated 24 July 2009

4 Please see our Alert: "Restricting pensions tax relief: The Coalition's alternative approach" dated 29 July 2010

- the Government welcomed Lord Hutton's interim report into public sector pensions (see below). They should be a "gold standard" but affordable. The Government will also consult on the Fair Deal policy[5] and on the appropriate discount rate used for actuarial valuations; and
- the Government accepted in full the Parliamentary Ombudsman's findings on the collapse of Equitable Life. It has announced its intention to pay compensation in the region of £1.5 billion – more than four times the figure recommended by Sir John Chadwick.[6]

Public Sector Pensions

The Public Service Pensions Commission

In June 2010, an independent commission was set up with a remit to review public sector pensions. Chaired by John Hutton, the former Labour Secretary of State for Work and Pensions, the Commission published its interim report on 7 October 2010.

Interim report

Increased contributions

The interim report suggests that there should be no structural change to public sector schemes immediately (the indication is that these will be delayed for four years). However, the Spending Review confirmed acceptance of Hutton's key recommendations that public sector workers will have to make additional member contributions in the short term. Hutton also recommends a review of the discount rate used for actuarial valuations in time for the final report (due by the 2011 Budget). A consultation on this is expected to be launched shortly.

Final report

Options for reform

In the longer term, whilst accrued rights will be protected, various options for more fundamental reform have been put forward, including: career average, unfunded DC, collective DC, and other risk sharing models such as hybrid schemes.

In the Spending Review, the Chancellor indicated that DB would be protected for public sector workers. Combined with Hutton's comments that final salary arrangements are "fundamentally unfair", this makes career average arrangements a frontrunner to replace current benefit structures.

Workplace Pension Reforms

Reforms given the green light

Employer duty of automatic enrolment starts October 2012

Having spent the summer reviewing Labour's plans[7] for the implementation of mandatory automatic enrolment into workplace pensions and the delivery of NEST, following the publication on 27 October 2010 of findings from an independent review (the Review)[8], employers will be required to start automatically enrolling "jobholders"[9] into their own qualifying pension arrangement or NEST from October 2012.

5 The Fair Deal is a non-statutory code of practice, providing pension protection for public sector workers whose employment is transferred compulsorily to the private sector (often as a result of outsourcing)

6 Sir John Chadwick was appointed by HM Treasury to advise on matters arising from the Government's Response to the Parliamentary Ombudsman's investigation into the prudential regulation of the Equitable Life Assurance Society – "Equitable Life: a decade of regulatory failure" (published 16 July 2008)

7 Please see our News "The Road to 2012: Building the foundations for new pensions saving" dated October 2009

8 Making automatic enrolment work, published on 27 October 2010

9 Eligible workers in Great Britain between the ages of 22 and State Pension Age

Pensions Reform (continued)

While the broad structure for automatic enrolment and NEST looks set to remain as originally planned, the Review recommends a number of improvements, many of which are designed to simplify the auto-enrolment process.[10] These include:

Simplified certification process

- an increase in the threshold for automatic enrolment to £7,475 in 2011/12, with contributions payable only on earnings in excess of the National Insurance primary threshold;
- simplification of the certification process for qualifying DC schemes; and
- an optional three-month waiting period before the automatic enrolment duty applies.

Although no exclusion is on the cards for small employers, the Review is "only content to recommend they remain within scope if other deregulatory options are implemented to ease their administrative burden". The Review also recommends the removal of the NEST restrictions on transfers, as well as a wholesale review "as a matter of some urgency" of how transfers in general can be made easier.

Further details are expected to emerge in due course, as the Government takes on board the Review's recommendations.

State Street Corporation appointed as fund administrator

NEST Administration

The fund administration contract for NEST has been awarded to State Street Corporation. The scheme administration contract awarded to Tata Consultancy Services by the former Labour Government will continue. These contracts are expected to be formally confirmed in late November by the NEST Trustees.

Pension Increases: RPI to CPI

DWP Update

In the Budget on 22 June 2010[11] the Government announced that CPI, rather than RPI, would be used for increases (both in deferment and to pensions in payment) to public sector pensions from April 2011[12]. On 8 July 2010 this was extended to private sector occupational pension schemes.[13]

Still awaiting consultation

Following some months of uncertainty as to how the change would operate, in particular for schemes where the reference to RPI is written into the rules, the DWP is expected to announce details of a statutory easement to assist schemes which would otherwise encounter difficulties making the change. We are expecting a consultation imminently.

Consequential changes

There have been a number of announcements on the move to CPI following the initial announcement by the DWP:

- Figures for Revaluation Order: The Office for National Statistics has announced that the rise in CPI for the year to September 2010 was 3.1%, whereas the rise in RPI was 4.6%. The CPI figure will be used for the annual Revaluation Order (normally published in December), which feeds through to public sector pension increases and certain increases in deferment. It is also used by some occupational schemes for increases to pensions in payment.
- Public Sector Pensions: Lord Hutton (see above) estimates that the change in the indexation measure could reduce liabilities in public sector schemes by around 15%.
- PPF Levy reduction: PPF compensation will also be increased in future in line with CPI. To reflect the reduced liabilities related to CPI, the PPF plans to set its levy estimate at £600m for 2011/12 – down from £720m this year.

10 Please see our Alert: "NEST comes home to roost!" dated 28 October 2010

11 Please see our Alert: "Coalition Budget 2010: Final economic remedies from Gladstone's Bag" dated 23 June 2010

12 Please see our Alert: "Pensions Increases – the change from RPI to CPI" dated 13 July 2010

13 A DWP press release on 12 July 2010 gave more details

Legislation

Equality Act 2010

In force since 1 October 2010

The majority of the Equality Act 2010 came into force on 1 October 2010. This Act is designed to harmonise discrimination law, bringing together and re-stating a number of anti-discrimination provisions.[14]

Age discrimination

Exemptions for pension schemes replicated

Regulations made under the Act include the Equality Act (Age Exceptions for Pension Schemes) Order 2010, which replicate the exceptions for pension schemes previously included in the Age Regulations.[15] These include exemptions setting out the rules, practices, actions and decisions which occupational pension schemes may use without breaching the non-discrimination rule, as well as those relating to contributions by an employer to a personal pension scheme. For example, the Order allows schemes to set a minimum or a maximum age for admission, or a minimum level of pensionable pay for admission to a scheme.

Sex discrimination

The Act also replaces the equal treatment rule from the Pensions Act 1995, which requires men and women to be treated equally in terms of the provision of occupational pensions, with an analogous sex equality rule.

The Equality Act 2010 (Sex Equality Rule) Exceptions Regulations 2010 reproduce the exceptions from the Pensions Act 1995 equal treatment rule, namely:

- bridging pensions;
- indexation; and
- the use of gender specific actuarial factors.

The Occupational Pension Schemes (Investment) (Amendment) Regulations 2010

Employer-related investment restrictions extended

The IORP Directive[16] (also known as the Pensions Directive) limits the amount which an occupational pension scheme can invest in its sponsoring employer to 5%. A transitional provision allowing schemes to retain certain investments in excess of the 5% limit expired on 23 September 2010.

Exemption for collective investment schemes expires

While UK regulations already included the 5% restriction, they also contained an exemption relating to investments in certain collective investment schemes.

Despite representations from Sackers and others that this exemption still met the Directive's requirements, following consultation on draft regulations these provisions have also been removed with effect from 23 September. Trustees of schemes affected by this change should check with their fund managers and custodians what steps can be taken to ensure that the trustees do not fall foul of the revised regulations.

14 Please see our News: "A new age of Equality" dated June 2010

15 The Employment Equality (Age) Regulations 2006

16 Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision

Regulatory

Department for Work and Pensions

Preserving powers to refund surplus – an update

Transitional provisions under the Pensions Act 2004 appear to prevent any payment being made to an employer out of scheme assets unless an appropriate trustee resolution is passed before 6 April 2011.[17]

Transitional period extended

Following concerns raised by Sackers and others, on 14 October 2010 the DWP replied to those who had contacted them, acknowledging the uncertainty about the scope and application of section 251.[18] (As currently drafted, it potentially applies to a wide range of payments to employers, for example, reimbursements of employer expenses.)

The DWP therefore intends to make it clear that section 251 only applies to payments covered by section 37 of the Pensions Act 1995 (essentially a payment of surplus to an employer from an ongoing scheme). The DWP also proposes to extend the deadline for action by five years to 6 April 2016.

We believe that it is reasonable for trustees to rely on this statement. However, trustees should be aware that there is a risk that the DWP will not take action before the power to pass a resolution under section 251 (as currently drafted) lapses in April 2011.

European Union

New EU pensions supervisory body

EU finance ministers have backed the establishment of four European financial supervisory bodies and agreed a draft regulation establishing their overall framework.

EIOPA to launch in 2011

Under these plans, the European Systematic Risk Board will have responsibility for overseeing the financial system, and three new supervisory authorities will be created, including a European Insurance and Occupational Pensions Authority (EIOPA) based in Frankfurt. National authorities will retain responsibility for day-to-day supervision of individual institutions.

The proposed set-up date for the new supervisory authorities is 1 January 2011.

AIFM Directive

On 26 October 2010, the European Parliament and Council announced that they had reached agreement on the Alternative Investment Fund Managers (AIFM) Directive.

Outcome of EU Parliament vote awaited

The Directive is designed to create an EU-wide regulatory AIFM framework for managers established in the EU. It will introduce "new and robust rules" on transparency, the safe-keeping of assets, risk management and leverage control, and will increase the powers of local regulators.

It will also launch a "passport" system to allow hedge funds authorised in one EU Member State to operate in any other EU Member State. Although initially only available to EU funds and their managers, non-EU alternative investment funds and managers who meet minimum regulatory standards and have agreements in place with Member States to allow information sharing will also eventually be able to market to investors across the EU.

The next step is for the EU Parliament to approve the Directive. At the time of going to press, this was expected to take place at the Parliament's plenary session on 11 November 2010. When the Directive comes into force, Member States will have two years to incorporate its provisions into national laws.

17 Please see our Alert: "Preserving powers to refund surplus" dated 24 May 2010

18 Please see our Alert: "Preserving powers to refund surplus: DWP clarification" dated 19 October 2010

HM Revenue & Customs

Tax simplification: End of transitional period ahead[19]

Transitional period ends on 5 April 2011

The Finance Act 2004 (FA04) brought in sweeping changes to pension scheme taxation, removing the old system of discretionary approval and Inland Revenue (IR) limits. This was replaced from A-Day[20] with a permissive system of authorised and unauthorised payments. If a payment is categorised as unauthorised under FA04 it will attract a penal tax charge – both for the member and the scheme.

Transitional Regulations[21] were put in place to prevent the change of regime having unintended consequences for pension schemes that took no action before A-Day. These transitional provisions preserved old-style IR limits, such as the earnings cap, and gave trustees and employers the power to refuse to pay benefits which are written into their scheme rules but which would now be unauthorised.

As the Transitional Regulations fall away from 6 April 2011, schemes that have yet to put a deed in place to deal with A-Day need to take action before then.

Tax treatment of protected lump sums

Payment of tax-free lump sums facilitated

Where an individual was entitled on 5 April 2006 to a lump sum under a particular pension scheme which exceeded 25% of the member's pension benefits, one of the conditions for the lump sum to be paid tax free was that the individual must become entitled to all of their benefits under the scheme (that were not in payment by 5 April 2006) on the same day.

This gives rise to difficulties for scheme administrators. It is usually impossible to start all scheme pensions (for example, main scheme benefits and externally secured additional voluntary contributions) on the same day, meaning tax protection for lump sums may be lost. A draft Order[22] therefore proposes to allow a period of up to three months between entitlements to scheme pensions to allow flexibility. Consultation on the draft Order closed on 31 October 2010.

Pension Protection Fund

PPF Levy for 2011/12

PPF Levy estimate reduced

The PPF's consultation on plans to reduce its levy estimate to £600 million for 2011/12 (see section on RPI/CPI above), also addresses a number of technical issues for the 2011/12 levy. These are designed to ensure that the weakest schemes are protected from shouldering the burden of paying for most of the levy as scheme funding improves (potentially reducing the levy for the strongest schemes). The proposals include:

- changes to the levy cap which protects the most vulnerable of schemes;
- the funding levels at which schemes will pay a reduced levy, or no levy at all; and
- the levy scaling factor which schemes use to calculate their individual levy bills.

The consultation closed on 4 November 2010. The PPF board plans to publish a summary of responses and a statement of the final policy in December 2010.

19 Please see our News: "Just when you thought it was safe to go back in the water..." dated August 2010

20 6 April 2006

21 The Registered Pension Schemes (Modification of the Rules of Existing Schemes) Regulations 2006

22 The Taxation of Pension Schemes (Transitional Provisions) (Amendment) Order 2010

Proposed changes to formula for calculating PPF levy

Consultation on PPF levy formula

The PPF is also consulting on a new framework for the pension protection levy. Its latest proposals include:

- fixing the levy rules for three years at a time to provide greater predictability (although these could be reviewed in exceptional circumstances); and
- using average measures for both underfunding and insolvency risk in order to increase stability. This would mean that any temporary changes in an employer's insolvency risk score, or pension scheme's funding position, would not disproportionately affect a pension scheme's levy bill.

The PPF intends that the formula will have a greater focus on factors in the levy payers' control, such as funding positions and investment risk.

The consultation closes on 20 December 2010.

Long-term funding strategy

The PPF plans to become financially self-sufficient by 2030. This goal was revealed in its first long-term funding strategy in which the PPF sets out how this funding target will be met by a combination of investment returns, proceeds from the assets of schemes brought into the PPF, and the annual levy on eligible schemes.

Cases

European Court of Justice

Association Belge des Consommateurs Test-Achats ASBL and Others

This Belgian case considers the use of sex-based actuarial factors for insured benefits – a practice permitted in the UK under the Equality Act 2010.

Background

Although the European Gender Directive[23] generally prohibits the use of sex as a factor which would result in different premiums and benefits for men and women for insurance products, there is an exemption for the use of sex as a determining factor in the assessment of risk (where it is based on relevant and accurate actuarial and statistical data).

The Belgian Government had taken advantage of this for life assurance contracts. Test-Achats (a non-profit making consumer organisation) brought an action for annulment on the basis that the law was incompatible with the principle of equal treatment for men and women. The case was referred to the ECJ.

Attorney General recommends removal of sex-based actuarial factors

Opinion of the Advocate General (AG)

The AG considered the use of sex-based actuarial factors to be incompatible with the principle of equal treatment for men and women and therefore considered the exemption in the Directive to be invalid.

The AG's opinion suggests that the exemption in the Directive should only be declared invalid for the future as, conceivably, millions of insurance contracts based on sex-specific risk assessments have been concluded since it came into force. She suggested a three year transitional period to allow Member States to decide what action to take and give insurance companies time to adjust to the new legal framework. After this, all insurance premiums and benefits would have to be based on sex neutral factors.

Although the ECJ is not bound to follow the AG's opinion, it is unusual for it not to do so. Should the ECJ declare this part of the Directive invalid, the effect on the purchase of annuities could be considerable. The ECJ's decision is expected in 2011.

Court of Appeal

Seldon v Clarkson Wright & Jakes

Background

A partner in a law firm, Mr Seldon, challenged his partnership's ability to justify its use of a compulsory retirement age of 65, claiming it was unlawful direct age discrimination.

The Court of Appeal (CA) focused on whether an employer can justify age discrimination using its own objectives or whether, following the decisions of the ECJ[24] and High Court[25] in *Heyday*, it must have social policy obligations.

Objective justification of a partnership's DRA

Decision

The CA held that the need for a social aim to justify discriminatory action related only to the UK Government and not to a private employer. Therefore, the CA was satisfied that the firm's aims, of providing employment prospects for young people and producing a "happy work place" (having a retirement age removed the need to use performance assessment), met this requirement. However, those aims must be "consciously recognised".

Age 65 was seen as an appropriate age for compulsory retirement, set against the backdrop of the UK's default retirement age (DRA) (which permits dismissal of employees from age 65 by reason of retirement).

23 Directive 2004/113/EC

24 Age Concern England v Secretary of State for Business Enterprise and Regulatory Reform Case C-388/07

25 R (on the application of Age UK) v Secretary of State for Business, Innovation and Skills [2009] WLR (D) 291

Cases (continued)

Consultation on the DRA
Since this case was decided, the Government has been consulting on phasing out the DRA from 6 April 2011. The consultation closed on 21 October 2010, with a response due in November.

Once the DRA disappears, an employer may have to work harder to objectively justify using a particular retirement age. But, following the above reasoning, it should not remove the possibility entirely.

Financial Support Direction imposed on Lehman Group companies

Background
On 15 September 2008, Lehman Brothers Holdings Inc. filed for Chapter 11 bankruptcy protection in the United States. On the same date, the UK company Lehman Brothers Limited (LBL), went into administration. As at 1 January 2007, the buy-out deficit in the UK DB scheme, the Lehman Brothers Pension Scheme (the Scheme), was approximately £150m.

Six companies to provide financial support

On 24 May 2010, TPR issued a warning notice of a financial support direction (FSD) against a number of companies in the Lehman Brothers group (the Targets) requiring support for the Scheme to be put in place. TPR relied on the statutory ground that the principal employer of the Scheme, LBL, was "insufficiently resourced".

In considering whether it is reasonable to impose an FSD, the key statutory test is whether the Targets in question had received any benefit directly or indirectly from LBL.

Determination
TPR's Determinations Panel (DP) held that it was reasonable to impose an FSD on:

- the US parent company, Lehman Brothers Holdings Inc;
- the three main UK operating companies within the UK; and
- two intermediate UK holding companies.

However, it remains unclear what proportion of the total deficit each Target will be liable for. We therefore await TPR's decision.

Administrators challenge TPR's enforcement powers

High Court Challenge
In addition, the UK administrators of both Lehman and Nortel have brought a High Court case, scheduled to begin on 24 November, challenging TPR's ability to enforce an FSD against an insolvent company in certain circumstances. We also await the outcome of this case.

Retrospective amendment declared void

Background
Section 67 of the Pensions Act 1995 sets out conditions which must be met to make an amendment to an occupational pension scheme. If these are not met, TPR has power to declare the amendment void.

Section 67 determination

Determination
The accrual rate in the ELCB Staff Pension Scheme (the Scheme) was reduced by an amending deed which sought to make the change retrospectively. The amendment came to the attention of TPR when the scheme entered a PPF assessment period in August 2007. The change had an adverse effect on members' subsisting rights, and the correct procedure under section 67 had not been followed.

However, despite the procedural infringements which could have defeated the amendment in its entirety, the DP only declared the amendment void to the extent that it applied retrospectively.

In the pipeline

Late 2010	Consultation on payment of pensions tax charges
1 January 2011	Establishment of EIOPA
6 April 2011	Switch from RPI to CPI as the statutory measure of price inflation for increases to pensions in payment and deferment
6 April 2011	Pensions tax relief restrictions implemented (reduced Annual Allowance)
Mid 2011	First payments from Equitable Life Payments Scheme?
6 April 2012	Lifetime Allowance reduced
6 April 2012	Abolition of DC contracting-out
1 October 2012	Start of phasing-in of employer duty to enrol jobholders automatically into NEST or a qualifying pension scheme
December 2012	Record-keeping targets in force

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