

pensions update

Pensions in the recession



Many media commentators have remarked on the increasing closure of defined benefit (DB) schemes to new members and to future accrual of benefits due to the adverse economic pressures employers supporting schemes are experiencing in the recession. The recession has, however, affected pensions in other ways that have not been as well publicised. This article looks at some less discussed impacts on pension schemes over the past few years caused in part, or in full, by the recession.

Employee pensions contributions reduced or stopped

HM Revenue & Customs official statistics have shown that the recession has had a severe impact on personal pension contributions to schemes with United Kingdom workers putting £1 billion less into their pensions in

2009/2010. There is no indication that the drop will be reversed in 2010/2011. Some leading firms involved in the provision of private personal pensions have noticed that 41% of the population are saving less because of the economic downturn. They have also estimated that up to 1.5 million workers may take a 'pensions holiday' in 2011 in their contributions to occupational pension schemes, as a guard against the continuing recession and as a reaction against widespread pay cuts, pay freezes and the rising cost of living.

PPF entry increases

The Pension Protection Fund (PPF) is a statutory fund that was established to provide a measure of protection for members of eligible DB occupational pension schemes. Entry is possible when the members' employer becomes insolvent, the scheme is eligible under the PPF rules and there are not enough assets in the scheme to provide the levels of compensation payable by the PPF. PPF entry is not guaranteed, even when a scheme has paid its PPF levy. The recession has increased the

number of PPF entries and there are now 212 schemes in the PPF, with a total of 409 schemes and 210,763 members in the assessment period. There is no indication that the numbers of schemes entering PPF administration are likely to reduce over the next few years.

Pensions Regulator assistance to employers in the current economic recession

The Pensions Regulator has emphasised the importance of prudent funding levels for pension schemes and has stated that where sponsors are in difficulty, flexibility is available in recovery plans. At the start of the recession, the Regulator issued a statement to employers who sponsor DB schemes, recognising that adverse economic conditions are of real concern to employers and commented:

- If any employer believes that an existing recovery plan is at serious risk of jeopardising the company's future health or solvency then they should discuss this with their pension scheme trustees.

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Reforming public sector pensions

Page 3



Abolition of the Default Retirement Age and the impact on pension schemes

Page 5



What's next in pensions?

Page 6

Welcome

I am pleased to bring you the spring edition of our pensions focus newsletter. As ever, we have attempted to touch on some topical issues, drawing on the experiences and concerns expressed by many of our clients.

I hope we have been able to road map for you what lies ahead in a quick and straight-forward manner. Please feel free to contact me if you wish - we are here to help.

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>>> continued from page 1

- The position of trustees of a pension scheme in deficit is akin to unsecured creditors of the sponsor organisation. They normally have a shared interest in maintaining the health of the company, as sponsors are in a position to make up shortfalls and in the event of insolvency pension funds generally fall behind payments to secured creditors.
- When the sponsor company is under pressure, there is potential to renegotiate previously-agreed plans to repair pension deficits (recovery plans). There is no reason why a pension scheme deficit should push an otherwise viable employer into insolvency. But the pension recovery plan should not suffer, for example, in order to enable companies to continue paying dividends to shareholders.
- The Regulator has already issued a statement to pension scheme trustees, drawing their attention to existing guidance, the circumstances under which they should consider reviewing and, if necessary, re-opening recovery plans.
- There may be exceptional circumstances if, for example, fresh equity is injected. Pension scheme trustees should be in a position to understand what is reasonably affordable for their sponsor, but all unsecured creditors must be treated equitably and the pension scheme not disadvantaged.

Defined contribution (DC) reforms proposed

The Regulator's team have commented that:

"We are focused now on improving standards of governance and better member

understanding in DC, which are important now in light of the recession, and are critical in the run-up to 2012."

In 2012, auto-enrolment starts with more than 1 million UK employers being required to enrol their employees into a pension scheme. The move towards auto-enrolment has been driven in part by the opting out or cut back in contributions that many workers have chosen to make because of adverse financial pressures on them caused by the recession.

Recognising that introducing auto-enrolment during a recession will be difficult, the Regulator has provided advice and assistance to employers. However, enforcement action against employers has also been threatened by the Regulator to tackle cases of deliberate non-compliance with auto-enrolment.

Regulator's action to ensure viability of schemes

The Regulator has wide-ranging powers to intervene in the running of occupational pension schemes. These are the Regulator's "anti-avoidance" powers (also referred to as the "moral hazard" powers) which allows him to issue contribution notices, financial support directions and restoration orders when the statutory criteria for their implementation allow. These powers are discussed in more detail in another article within this issue of *Pensions update*, and so will not be commented on further in this article, except to say that there has been a noticeable increase in the implementation of these powers during the course of the recession.

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Reforming public sector pensions

In a recent research report, Pricewaterhouse Cooper (PwC) estimated how much a 21 year old public sector employee would receive at retirement at age sixty, compared with someone of the same age, who spent his whole working life in the private sector. PwC stated that the public sector worker would receive a pension of £28,900 compared to just £11,600 for the private sector worker.

Interim Hutton Report

All of the major UK political parties made promises to reform public sector pensions during the course of the 2010 general election campaign. David Cameron stated: "We have got to end the [pensions] apartheid... There is an issue of fairness between the private sector and the public sector". The Coalition Government established an independent commission to review the long term affordability of public sector pensions which published its interim report late last year. It called for significant reform of public sector pensions. Some of the key findings of the interim report are:

- many of the current public service pension design features, including accrual rates, pension ages and the link to final salary, date back nearly 200 years, despite the enormous upheavals in demography and in the nature of work in our economy;
- the evidence shows that current pension structures, combined with the requirement to provide comparable pensions (under the Fair Deal provisions), are a barrier to non-public service providers, potentially reducing the efficiencies and innovation in public service delivery that could otherwise be achieved;

- the Coalition Government changed the measure of annual price movements, so that from April 2011 onwards pensions up-rating will move from the Retail Price Index to the Consumer Price Index. This change in the indexation measure may have reduced the value of benefits to scheme members by around 15% on average.

The interim Report considered a range of options that may provide short-term savings, specifically:

- changing the benefits structure;
- contracting public service pension schemes into the State Second Pension; and
- increasing contribution rates

However, the most effective way to make short-term savings was said to be the increase of member contributions.

Final Hutton Report

The final Hutton Report was published on 10 March 2011. The range of alternative structures that were considered in the final Report included:

- a career average alternative to the current final salary defined benefit schemes in public sector schemes;

- looking at alternatives, such as Sweden's use of notional defined contribution schemes and the Netherlands' collective defined contribution schemes will be examined;
- looking into risk sharing models, such as hybrid schemes that combine elements of defined benefit and defined contribution models; and
- considering elements of scheme design, such as, ensuring normal pension ages are in line with the latest developments in longevity.

The final Report made 27 recommendations for the Government to consider in reforming future pension arrangements in the public sector. The Commission's view is that defined benefit (DB) should continue to be the basis on which public service pensions are run and designed. In so doing, public sector employees' pension entitlement will still be linked to their salary. However, the Report recommends that a "Career average revalued earnings" (CARE) scheme be introduced for current public sector workers. CARE schemes are a type of DB scheme in which the member's pension at retirement is calculated using their average salary over the entire period of their service with the employer, rather than being based on the "final salary" an employee is paid, at the time of retirement.

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>>> continued from page 3

Other key recommendations in the final Report

- Linking Normal Pension Age (NPA) in most public service pension schemes to the State Pension Age.
- Introducing an NPA of 60 for those members of the uniformed services who currently have a NPA of less than 60.
- Setting a clear cost ceiling for public service pension schemes – the proportion of pensionable pay that taxpayers will contribute to employees’ pensions – with automatic stabilisers to keep future costs under more effective control.
- Honouring, in full, the pension promises that have been earned by scheme members (their “accrued rights”) and maintaining the final salary link for past service for current members.
- Introducing more independent oversight and much stronger governance of all public service pension schemes.

Government withdraws the Code of Practice in Workforce Matters in Public Sector Service Contracts

On 13 December 2010, the government announced that it was withdrawing the Code of Practice in Workforce Matters in Public Sector Service Contracts with immediate effect. The Code of Practice (CoP) was introduced in March 2005, in order to apply the principles set out in the Cabinet Office Statement of Practice on Staff Transfers in the Public Sector, sometimes known as COSOP.

What did the Code require?

The Workforce Matters in Public Sector Service Contracts CoP applied to public sector service contracts which involved a transfer of staff from the public sector organisation to the service provider. It also applied to staff originally transferred out from the public sector organisation as a result of an outsourcing and who were then subsequently TUPE transferred to a new provider under a re-tender of a contract. The CoP formed part of the service specification and conditions for all such contracts, except those where the Best Value Code of Practice on Workforce Matters in Local Authority Service Contracts. The Best Value CoP has not been withdrawn and continues to contain different requirements to the Workforce Matters in Public Sector Service Contracts CoP, which has been withdrawn.

The CoP was designed to prevent the emergence of a two-tier workforce when public sector employees are contracted out to a new service provider. New recruits (i.e. those subsequently employed directly by the contractor) were to receive comparable treatment to the transferred staff, whose terms and conditions are protected by the TUPE Regulations.

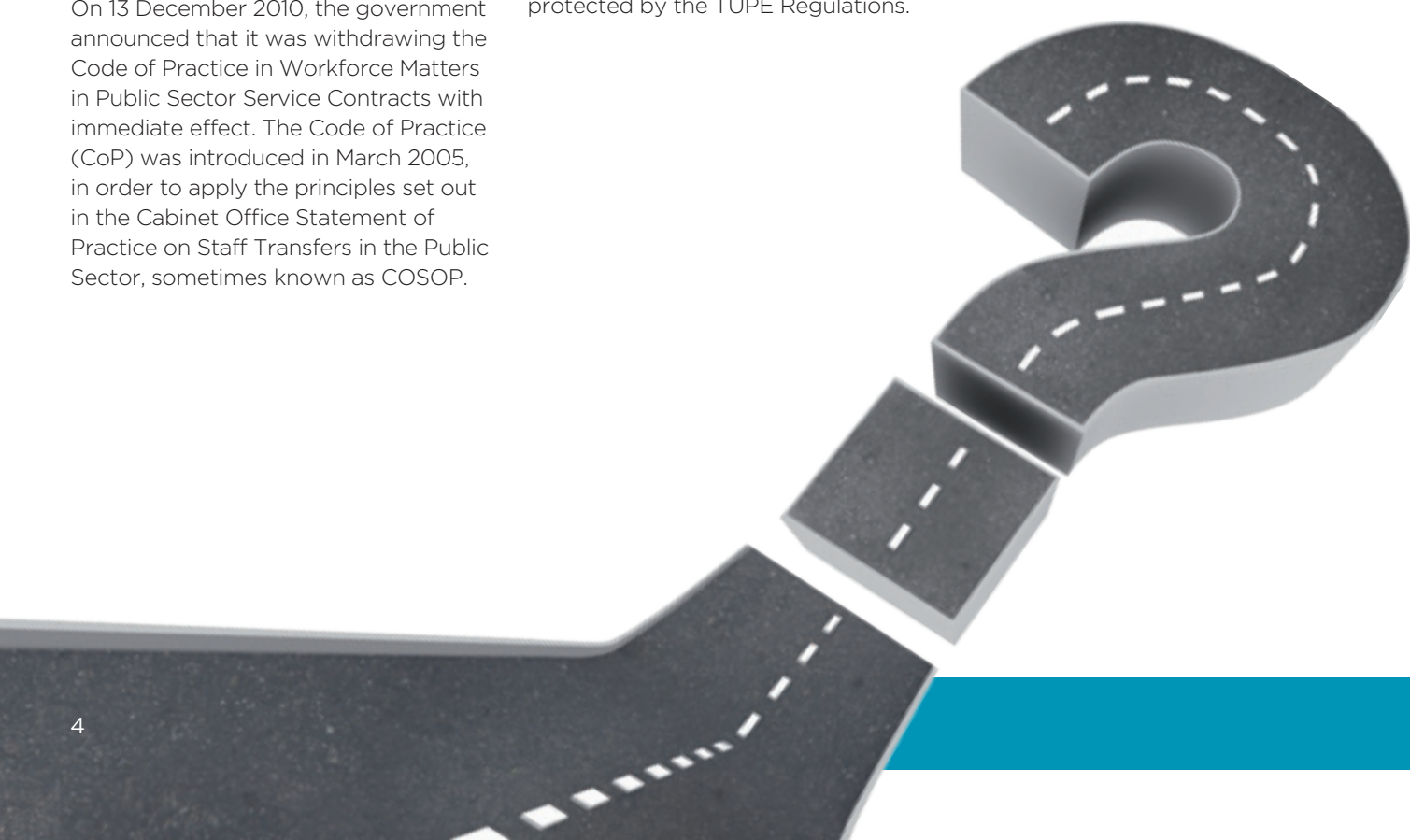
What is the effect of the withdrawal of the Code?

The withdrawal of the CoP does not impact on existing TUPE regulations and provisions in the Employment Act 2008. Neither does it reduce or remove the statutory duties on public authorities to have due regard to the need to eliminate unlawful discrimination, and to promote equality of opportunity - which can apply to contracting authorities and to suppliers in some circumstances.

The decision to remove the CoP has no immediate effect on the obligation of public sector bodies to provide broadly comparable benefits, which applies in respect of transferring public sector employees by virtue of the Treasury’s Fair Deal provisions. Fair Deal is currently under review by the Coalition Government and proposals to reform it are the subject of a consultation issued by the Department for Work and Pensions.

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Abolition of the Default Retirement Age and the impact on pension schemes

Since 2006, UK law has prohibited age discrimination in the workplace. An exemption in the Employment Equality (Age) Regulations 2006 currently allows employers to oblige staff to retire at age 65 (the Default Retirement Age) although employees can request to work beyond that date. It was expected that the Default Retirement Age (DRA) would be reviewed in 2011, to assess whether it should be retained. However, that review was brought forward as a result of the High Court's decision, in the 'Heyday' case, which held that the DRA was not unlawful when introduced in 2006, but there is now a compelling case for it to be scrapped.

On 13 January 2011, the Government confirmed in the response to its consultation paper issued on 29 July 2010, that the DRA would be phased out from 6 April 2011, coming to an end on 1 October 2011.

Occupational pension schemes

The Government states in the response that it:

"...considers that the removal of the DRA does not affect occupational pension schemes. The absence of a DRA does not affect the setting of a 'normal retirement age' or 'normal pension age' for the purposes of occupational pension schemes".

Whether, in practice, the removal of the DRA will affect occupational pension schemes is not yet clear. Flexible retirement and the desire amongst employees to continue to accrue pension benefits, or draw their pension whilst continuing in the employer's service, is likely to become more popular following the abolition of the DRA.

A recent article in *Professional Pensions* refers to research indicating that a third of employers believe abolition of the DRA will prompt them to better promote their pension scheme and rethink their practices for older people. Employers will inevitably think about the pension scheme as a tool to encourage older people to give up work by ensuring they have sufficient pension income to afford to retire.

Group risk insured benefits

The Government has said that it intends to introduce an exemption to the principle of equal treatment on the grounds of age where group risk insured benefits are provided by an employer; such as income protection, death in service benefits and health insurance. The Government is of the view that this is the safest way to guard against these benefits either being greatly reduced or withdrawn.

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Professional Pensions "Abolishing DRA will bolster company scheme promotion", 24 January 2011 (research conducted by Hargreaves Lansdown).



The Pensions Bill 2011

A recent Pensions Week survey asked pension professionals what their biggest pensions concern is for 2011. They found that people were most concerned about there being too much legislation introduced, too soon, and that offerings could become so complex that they will overwhelm people out of the market. It is against this background that the government introduced the Pensions Bill into Parliament earlier this year. The Bill introduces measures to:

Implement automatic enrolment

- The principle of automatic enrolment has already been debated in Parliament during the passing of the Pensions Act 2008. The Government committed to that principle.
- The Bill will tweak some of the parameters of the policy to ensure that automatic enrolment works as effectively as possible.
- The Government propose a slight increase to the earnings threshold at which automatic enrolment is triggered, aligning it with the basic rate tax threshold. This simplifies administration by aligning automatic enrolment with existing thresholds that employers use.
- The Government believe that this measure will create a buffer against very small contributions, without creating a significant contribution “cliff edge” (Parliamentary Under-Secretary of State, Department for Work and Pensions, Hansard: 15 February 2011: Lord Freud)¹.

Ease the regulatory burden on employers by allowing a waiting period of up to three months

- This is on the footing that employers must provide a notice of their intention, to invoke a waiting period and employees are able to opt in to pension saving if they wish to do so within this period.

Bring forward the timetable for increasing the State Pension age to 66

- State Pension ages for men and women are to be equalised at age 65 from 2018, and jointly increased to 66 by 2020.

Effect the change from the Retail Prices Index (RPI) to the Consumer Prices Index (CPI) as a measure of indexation for schemes

- There is an amendment within the Bill to ensure schemes are not required to increase pensions in payment by the higher of RPI or CPI will affect the expected value of the pensions of pension scheme members. There will be a corresponding decrease in the expected value of the pensions' liabilities of pensions providers.
- Legislation is to be passed that will excuse those schemes providing RPI from providing a CPI underpin.
- The Bill does not provide a statutory modification power which would have made it easier for a scheme to switch to CPI, where RPI is ‘hot-wired’ in the scheme rules, so schemes will need to consider the impact of this new legislation on their ability to make these changes.

Alter pensions protection legislation

- The most significant Pensions Protection Fund (PPF) related measure is the indexation of pension compensation by CPI rather than RPI. This has been done to ensure consistency with changes to other pensions' indexation. The change to the revaluation rules for pensions' compensation is to be taken forward by regulations made under the Bill.
- Create eight further pensions protection measures relating to the PPF amended legislation with the aim of reducing unnecessary bureaucracy, time and/or resources; clarify the policy intent; or enhance existing rules.

Change Pensions Regulator powers

- The Bill amends time periods relating to the Regulator's anti-avoidance powers, with the aim of ensuring the statutory time periods operate fairly for business particularly in cases with inherent complexity (for example where the companies involve large multi-national or multi-employer groups).

Introduce a number of minor or corrective amendments, primarily to pensions legislation

- These measures clarify or change the original policy, or align with further reform proposals or, in a few cases, are technical amendments to correct inaccuracies in legislation. For example, the Bill repeals the requirement in Section 151 of the Pensions Act 2004 that an application for reconsideration by the PPF must include a “protected benefits quotation”.
- This change is due to the PPF Board advising that many schemes find it impossible to obtain a quote and that the repeal would reduce bureaucracy for the PPF Board.

Amend “surplus rules”

- Section 251 of the Pensions Act 2004 gave trustees a transitional power to confirm or amend powers in scheme rules to make payments to the employer. The Bill amends Section 251 so that a resolution to repay surplus to the employer can be passed no more than once after 6 April 2011, and extends the time limit in which a resolution can be passed, to 6 April 2016.

We will keep you informed on the progress of the Bill, which at the time of writing had reached its Second Reading in Parliament. The full text of the Bill is available using this link: <http://services.parliament.uk/bills/2010-11/pensionshl.html>

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¹The information that follows is sourced from the Bill and guidance issued by the Government which accompanies the Pensions Bill 2011.

What's next in pensions?

This overview focuses on some of the legislative changes that will apply to occupational pension schemes in the future. Please contact Andrew Ashley Taylor if you would like further information on any of the topics mentioned below.

Default Retirement Age (DRA) 6 April 2011

Draft regulations published in February 2011. The regulations that will abolish DRA should be in force by April 2011, subject to Parliamentary approval.

Annuitisation 6 April 2011

The Government has confirmed draft legislation will be introduced in the Finance Bill 2011, to remove pensions tax rules that currently create an obligation for members of registered pension schemes to secure an income, usually by buying an annuity, by age 75.

'A-Day' transitional changes cease 5 April 2011

'A-Day' transitional regulations, which allowed some temporary modification of existing Inland Revenue approved schemes to allow old HMRC limits to apply, cease to apply.

Reduction in annual allowance 6 April 2011

The annual pension allowance has been reduced to £50,000 and the lifetime allowance cut from £1.8 million to £1.5 million.

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RPI to CPI October 2011

RPI is to be replaced by CPI as the measure of inflation of minimum requirements for the revaluation of deferred pensions, or increases of pensions in payment. Replacement will be effected by Pensions Bill 2011.

Automatic enrolment October 2012

Coalition Government to initiate auto-enrolment, but with transitional provisions applying and NEST available to employers. Pensions Bill 2011 'tweaks' previous Government auto-enrolment rules.

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