Spence & Partners Limited – Industry Changes

Your Quarterly Pensions Update – Q4 - 2018

SPENCE

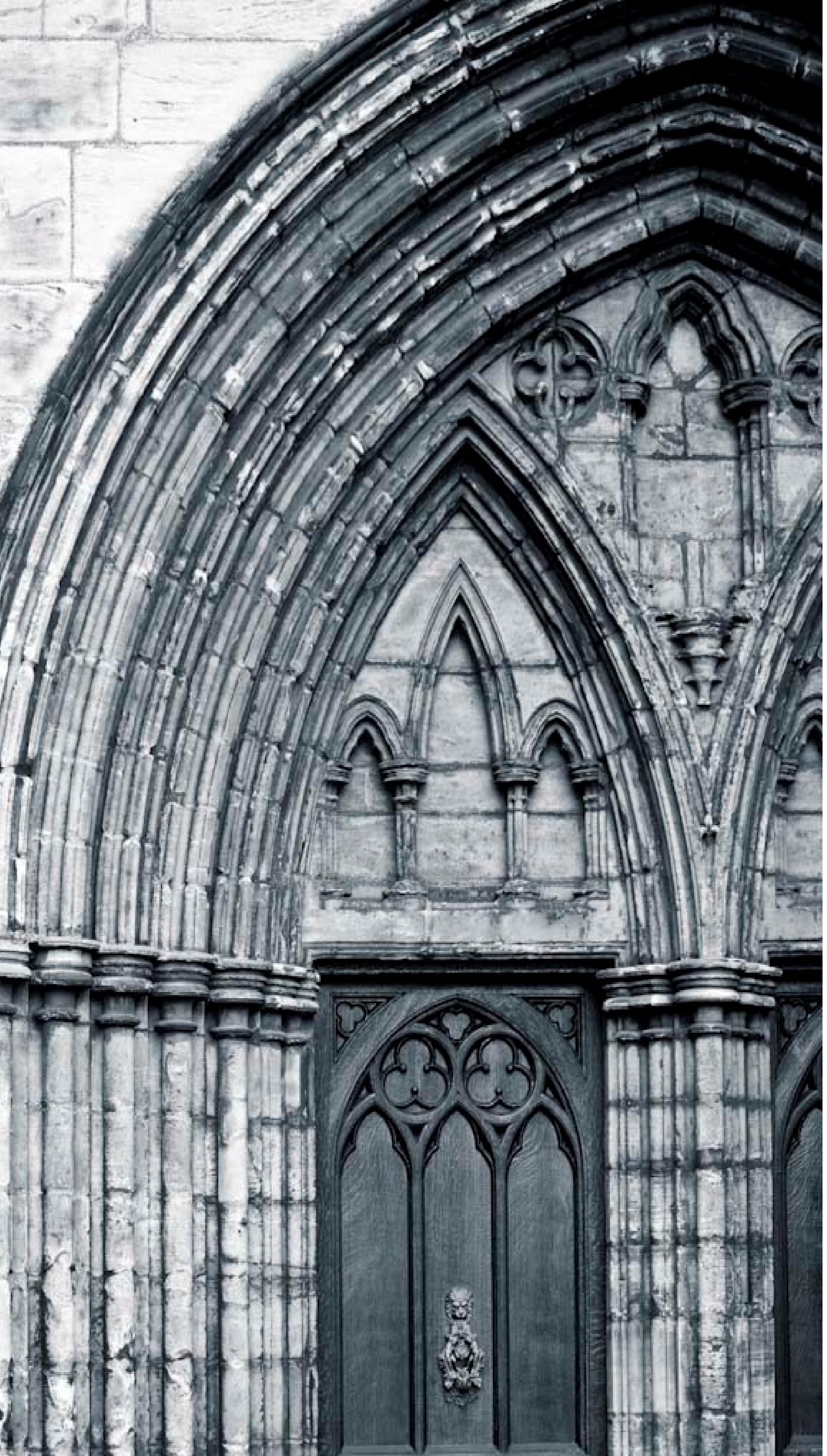
What's inside?

ACTUARIAL

ADMINISTRATION

INVESTMENT

GOVERNANCE



Introduction

Welcome to your Quarterly Pensions Update.

The purpose of this report is to update sponsors and trustees with recent pensions industry changes in the quarter.

For your convenience, Spence has summarised the key developments and highlighted the necessary actions sponsors and trustees may need to take.

The report combines brief written comment with links to any further relevant information and any deadlines you should be aware of. We trust you will find the update useful and informative. If you require further information about how any of the topics covered might impact on your scheme specifically, please get in touch with hugh_nolan@spenceandpartners.co.uk or your usual Spence contact.

NOTE

This document is aimed at providing you with generic information about recent developments in the pensions industry.

You should not take any action as a result of information included in this document without seeking specific advice in relation to the impact these matters might have on your scheme or company. Spence & Partners Limited accepts no liability for actions taken or not taken as a result of this document.

The Confirmation on the PPF Levy Rules 2019/20

The PPF has issued its final levy rules for the 2019/20 levy year, following the closure of its earlier consultation in September 2018. These new rules will be applicable from 1 April 2019. The full policy statement for the 2019/20 PPF Levy can be found at the link below.

In short, the PPF has confirmed its levy estimate of £500 million for the 2019/20 year. This is a 10% reduction from the £550 million estimate from 2018/19.

As expected from the earlier consultation, the 2019/20 rules remain largely unchanged from those that applied in the 2018/19 levy year.

The main points to note are:

- The Levy Scaling Factor of 0.48 and the Scheme-based Levy Multiplier of 0.000021 (both unchanged from the previous year) have been confirmed.
- There have been no significant changes to the measurement of insolvency risk.
- Schemes with certain types of contingent assets (i.e. Type A and Type B) that are seeking levy credit for the 2019/20 year will need to re-execute and submit hard copy documentation to the PPF by 5pm on 1 April 2019 (Note however that all information must be entered online by midnight on 31 March 2019).
- Following the views expressed during the consultation, it has been agreed that Pension Increase Exchange options should not be treated as augmentations for the purposes of deficit reduction contribution calculations.
- Exempt Transfer application forms should be sent to the PPF by 30 April 2019.

In addition to the above, the PPF has also established an approach for calculating a levy for commercial consolidators – this has been published by the PPF as the Commercial Consolidator Appendix (linked below). It provides the formulae for calculating the Risk-based Levy for such schemes. This follows on from the government's White paper on DB schemes earlier in 2018, which included plans to promote consolidation in the DB sector as a means to addressing funding shortfalls and improving regulation.

The Confirmation on the PPF Levy Rules 2019/20 Continued…

ACTION

Trustees that rely on contingent assets to reduce their PPF levy should review these and re-execute them accordingly. The PPF issued new standard forms for this process – see link below.

In general, trustees should contact their scheme advisors to establish if there are any actions that can be taken to reduce their levy.

The deadline for submission of relevant information is 31 March 2019 – trustees should ensure their advisors have submitted the key documentation (including monthly Experian Scores, scheme returns, contingent asset certificates and special category employer applications).

Helpful Links:

- 2019/20 Levy Rules and Policy Statement
- Commercial Consolidator Appendix

Investment Market Update

Equities performed poorly over Q4 of 2018, as global recession fears increased and investors de-risked into "defensive" asset classes like gold and sovereign debt. This was driven by rising US central bank interest rates, a slowdown in Eurozone business confidence, tightening global liquidity due to the withdrawal of quantitative easing and weaker Chinese growth. Rising geopolitical concerns added fuel to the fire sale, including Brexit, Italian politics, US political gridlock, and the ongoing trade conflict between the US and China.

Brexit continues to be the inescapable, primary concern, as worries of a "no deal" exit from the EU increased after the UK published its draft EU Withdrawal Agreement in November, which triggered further political uncertainty. Several ministers resigned in protest following the agreement, raising questions over both the stability of the UK government and whether Parliament would agree on the deal. This instability looks to be continuing into 2019 – no doubt our Q1 update for 2019 will have a paragraph (or two) dedicated to Brexit concerns!

Emerging markets performed negatively over the last quarter of 2018, but were better than their developed counterparts over the period; however they had declined more throughout the year. Mexico was among the weakest performer due to concern over the incoming government's policies and the implications for investment.

Brent crude oil fell 35% due to rising crude inventories and increased production, in addition to fears that global growth may be slowing. As many oil companies issue high yield debt, default rates could increase across the sector if the oil price does not increase.

Gilts and other major government bonds performed well over the quarter due to their status as a safe-haven asset. This caused credit spread to increase as government bond yields fell.

ACTION

Trustees should continue to monitor their investment portfolio at regular intervals and liaise with their investment advisors to ensure that their scheme's investment strategy remains appropriate.

HMRC and The Pensions Regulator Warning over Member Tax Relief

HMRC and TPR have highlighted the need for Pension Scheme Administrators to check that member contribution tax relief is being correctly applied.

Tax relief is claimed by two main methods, 'Net Pay' and 'Relief at Source'. Under Relief at Source, the employees' earnings are taxed first and contributions then deducted from the net pay. Tax relief should then be claimed by the Scheme Administrator from HMRC. Under Net Pay, contributions are calculated and deducted before the application of tax so that there is no need to claim tax relief from HMRC.

The problems occur when the organisation dealing the employee payroll and the organisation dealing with the remittance of pension contributions are not correctly aligned. For example, overpayments caused by member contributions being paid before taxes are deducted and an administrator then claiming tax relief from HMRC via a 'Relief at Source' payroll. This type of error led to £10m in tax relief being paid twice to a company's employees, over the space of 6 years!

Trustees and their Pension Scheme Administrators need to ensure that their tax relief process is correct and consistent from start to end so that no nasty surprises emerge.

To help schemes navigate this problem, TPR has provided a code of conduct (linked below). HMRC have also advised that if administrators think any pension scheme members have been given the wrong amount of tax relief, an email should be sent to pensions.businessdelivery@hmrc.gsi.gov.uk with the heading 'Newsletter 105 - Pensions tax relief' in the subject line of the email. HMRC will then help correct the tax position and make sure the members get the tax relief they're due.

ACTION

Trustees and their Pension Scheme Administrators should review their tax relief processes, whilst also ensuring that their member data is up-to-date, accurate and correctly accounts for contributions.

Helpful Links:

- TPR Code of Conduct

Master Trust – Triggering Event Duties

The Pensions Regulator ("TPR") has published guidance for those involved with the running of master trust pension schemes. This outlines triggering events which may indicate the scheme cannot continue to operate, and how these should be managed.

What are Triggering Events?

The Regulator lists 11 specific events in the guidance. These largely relate to question marks over the viability of the scheme, which could be triggered by the scheme funder, trustees or the Regulator. More details on who must report and the deadlines for each event are available in the guidance linked below.

Notifying a Triggering Event

If a master trust experiences a triggering event, there is a requirement to notify TPR. The deadline for this will depend on the event, but timescales can be as short as 7 days of the event occurring. There is a form available on TPR's website (see links below) to update with the event details.

TPR recommends that advice is sought if there is any uncertainty over whether an event has occurred. In order to report an event, the reporter must understand the identities of the scheme funder (the entity liable to provide funds to the scheme, or who would receive profit from it) and the scheme strategist (the entity or individual responsible for the business decisions and commercial activities for the scheme). Guidance on identifying scheme funders and strategists is also provided.

Implementation Strategy

Where a triggering event has occurred, the trustees must either:

- Resolve the triggering event to continue operating; or
- Transfer out all members and wind up.

The trustees must set out an Implementation Strategy within 28 days of the triggering event setting out which of the above they have elected. This will include their plan on how this will be resolved.

There are various restrictions on how trustees conduct business during this period. These are detailed within the guidance. The process must be followed until the event is fully resolved, and the appropriate form is completed.

Master Trust – Triggering Event Duties Continued…

Failure to comply

Failure to comply with the requirements may result in a penalty of up to £5,000 for an individual and £50,000 in any other case.

ACTION

Trustees should be aware of all the Triggering Events and understand their obligations. In the event of any uncertainty, trustees should contact their scheme advisors immediately.

Helpful Links:

- New TPR Guidance
- Triggering Events Form
- Identifying Scheme Funders and Scheme Strategists

From Qinetiq and beyond – indexation back in the spotlight in Barnardo’s appeal

Avid readers of our quarterly update might recall this case, which relates to the measure of inflation used to determine scheme benefits in the Barnardo’s pension plan. Last November, the Supreme Court dismissed Barnardo’s appeal, thereby confirming consistency with the previous QinetiQ and Arcadia decisions on switching indexation from RPI to CPI without amending the scheme rules. The ruling maintains the status quo, so that each scheme will need to seek advice to confirm it can substitute CPI for RPI.

Historically, RPI was used as the primary measure of inflation for pension schemes in the UK. However in 2010 the government chose to switch to using CPI as the basis of annual increases in public service pensions. Because of the possible significant reduction of liabilities many schemes wanted to follow suit. Barnardo’s was no exception.

Barnardo’s Case

The case centred on the precise definition of RPI in the scheme rules. The main issue before the court was whether the trustees had the power under the scheme's rules to substitute CPI, or some other index, for RPI. The appeal focussed on the definition in the rules of "Retail Prices Index", which was *‘the General Index of Retail Prices published by the Department of Employment or any replacement adopted by the Trustees without prejudicing Approval.”*

Particular attention was paid to the words *"or any replacement adopted by the Trustees without prejudicing Approval"*. Specifically, did these words mean:

- RPI or any index that replaces RPI and is adopted by the trustees?
- RPI or any index that is adopted by the trustees as a replacement for RPI?

The Court held that the meaning contained in the first bullet point was correct. As RPI was still being published by the relevant authority, it had not been replaced by another form of index. It was still available alongside CPI and there was no “replacement” the trustees could use.

The members’ representative also raised an issue concerning section 67 of the Pensions Act 1995. The Court held that a switch from RPI to CPI was not viewed as a detrimental modification for section 67 purposes, thereby approving the approach in the QinetiQ case.

From Qinetiq and beyond – indexation back in the spotlight in Barnardo's appeal Continued…

Indexation gave rise to no accrued rights until the calculation had been done. Both the appeal and the cross-appeal were rejected.

ACTION

The ability of a scheme to switch from RPI to CPI may have significant impact on the liabilities of the scheme and represent a significant saving for the sponsoring employer. Trustees and employers should take appropriate advice on the provisions of their scheme rules to determine whether there is the ability under law to select a different index. Note that Barnardo's definition was unusual and each scheme will have its own particular wording

Helpful Links:

- Barnardo's and others v Buckinghamshire and others [2016] EWCA Civ 1064 - Judgment

Brexit

There is little argument that Brexit has and continues to dominate the political and business agendas. The outcome as to whether and how we leave the European Union is uncertain. As Theresa May said outside Downing Street after presenting her deal to cabinet back in November, there are three options:

- Back the deal
- Have a no deal Brexit
- Have no Brexit.

Since making that statement the first option has been subject to the fiercest of defeats in the House of Commons – the largest defeat for a sitting government in history in fact. The reaction in Europe has been relatively consistent (and muted) with officials making it clear that no further negotiation is possible (at least until Parliament can reach an agreement on where they want to go next) and that preparations have started for a no deal Brexit.

So how do your scheme's trustees deal with this uncertainty when considering the impact for your scheme? Uncertainty means risk and risk is something that your trustees can understand, record and plan for.

Spence has been considering this and talking to employers and trustees about managing this risk. The approach has been to look at the worst case scenario – a no deal or chaotic Brexit. We tend to consider four areas where a no deal Brexit might have most impact:

- Covenant - is the sponsoring employer prepared for a no deal Brexit and what risks do they envisage to their operations?
- Actuarial – is the scheme's valuation still current, are contribution levels appropriate, are buy-out prices for DB schemes more attractive?
- Investment – is the current investment strategy appropriate for current market conditions? Do Fund Managers have a Brexit plan in place (they should!)?
- Administration – what communications do the members need, as they may be worried about the security of their benefits?

This video features Spence experts in these areas, talking about how Brexit might affect your scheme and answering those and other key questions.

GMP Equalisation – all things being equal

After nearly three decades of uncertainty, late last year the High Court published its long awaited judgment that UK pension schemes must remove the remaining elements of sex inequality from benefits built up since 17 May 1990. While there continues to be no one-size-fits-all solution, we now have 174 pages of guidance and analysis that will help inform how this should be done.

What was the problem?

The government used to provide a second 'top-up' pension called the State Earnings-Related Pension Scheme (SERPS). Under the old State pension rules, an employee was able to opt-out (or "contract out") of SERPS, whereby in return for reduced National Insurance Contributions the employer would commit to providing a certain level of pension (a Guaranteed Minimum Pension, or GMP). Mirroring the State benefit structure, the GMP is unequal between men and women – not least in that it is based on a retirement age of 60 for women and 65 for men. Therefore, since 1990 pension schemes with GMPs have had to comply with two seemingly incompatible pieces of legislation – on the one hand to provide benefits which are sex equal, and on the other hand to comply with GMP rules which are sex unequal. No wonder then that this is a problem that has been kicked down the road for a generation.

Lloyds Banking Group Pensions Trustees Limited v Lloyds Bank PLC and others

Prompted by individual equality claims to the Employment Tribunal, much of the uncertainty surrounding the issue of GMP equalisation has been resolved by the recent case of Lloyds Banking Group Pensions Trustees Limited v Lloyds Bank PLC and others. In summary, the Court decided that:

- State benefits do not need to be equalised, but GMPs cannot be treated as State benefits;
- Trustees and employers cannot justify the differential caused by GMPs so they must correct it via the main Scheme benefits;
- The requirement to equalise GMPs applies to benefits accrued between 17 May 1990 and 5 April 1997;
- Trustees must change Scheme rules to comply, but can only do so without employer consent if they do the minimum necessary to comply;
- A number of methods of equalising for GMPs are possible and a scheme sponsoring employer has influence over the method that can be adopted;
- Trustees are obliged to make back-payments to members, although, depending up on the Scheme's Rules (in particular its forfeiture rule), it may be that the period of back-payments will be restricted; and

GMP Equalisation – all things being equal Continued…

- Simple interest is payable on the back-payments and should be paid at 1% above base rate.

What is the likely impact?

It is not a straightforward job to calculate the effect of GMP equalisation on members' benefits. The calculations are complex and in many cases the data needed for the calculations will not be readily available. The overall increase in liabilities for affected schemes is likely to be fairly small, but the costs may be significant relative to the impact on benefits. The actual impact is difficult to predict and, as well as being dependent upon the Method chosen, is also a function of the Scheme membership and benefit structure.

Scheme sponsors will inevitably be interested in the outcome, and they should seek confirmation from their auditors as to how this additional cost will be treated e.g. as a past service cost in their P&L account or as a change in assumptions in Other Comprehensive Income (the "OCI"). In addition, there will be funding implications arising from both the additional liabilities and increased administrative costs.

So we now have certainty?

Not quite. Firstly, aspects of the judgment may be appealed. Secondly, the judge didn't answer the question as to whether there is an obligation to equalise benefits transferred out of the Scheme. Thirdly, on a practical point, there are questions as to whether or not administrative costs can be taken into account in deciding between methods and the extent to which members will understand a method can be factored into this choice. Finally, there are risks of unauthorised payment charges and loss of existing protections – and while HMRC have been invited to change their approach to ensure all benefit corrections are authorised, they have yet to confirm their stance on this.

What should we be doing?

Generally, we suggest taking a considered approach, particularly as elements of the case could still be appealed.

Nevertheless, trustees will need to think carefully about how to start to address this issue in their schemes, including seeking legal and actuarial advice on the GMP equalisation method that will be most suitable for them, as well as considering how to deal with past underpayments, past transfers out and buy-in policies already in place.

Employers will also need to consider how to account for this additional liability.

PPF Purple Book

Just in time for Christmas, the PPF issued the 13th edition of the Purple (Pension Universe Risk Profile) Book, the most comprehensive data on the UK universe of private sector defined benefit pension schemes. This year it covers 5,450 schemes – 98.7% of the universe eligible for PPF compensation.

Scheme demographics

According to the book, the proportion of schemes open to new members remained fairly stable (compared to 2017) at 12%, with schemes closed to future accrual rising to 41%. The decline in DB pension provision is stark when comparing these figures to the 1st edition only 12 years ago (43% and 12% respectively).

The Purple Book dataset includes 10.4 million DB scheme members. Out of those members, 41% are pensioners, 47% are deferred members and 12% are active members. The figure of 1.3 million active members is down from 3.6 million in 2006.

Scheme funding

Scheme funding has improved since the previous report, with the deficit on a PPF s179 section basis more than halving to £70.5 billion in deficit (£161.8 billion in deficit in 2017).

This can be attributed to up-to-date valuations, the shrinking dataset, as well as higher gilt yields reducing liability values and favourable equity market returns. The seemingly never-ending flow of deficit contributions are also playing their part.

Asset allocation

The decline in equity investment continues, falling from 29% to 27%, while the proportion invested in bonds rose from 56% to 59%. There has been a decrease in allocation for assets other than bonds and equities, although this could be attributed to an increased use of derivatives.

Perhaps unsurprisingly, the proportion invested in UK equities fell in favour of overseas quoted equities. The allocation in private equity has also been on the rise.

PPF Purple Book Continued…

PPF levy, claims and compensation

In 2017/18, the levy totaled £541 million, down slightly from the previous year.

- The top 100 levy payers accounted for as much as 42% of the total levy, similar to last year.
- Almost 1 in 5 schemes were deemed sufficiently low risk to benefit from nil risk-based levy, whilst at the other end of the scale around 140 "high risk" schemes paid a capped levy.
- Over three quarters of the total levy came from "large" or "complex" schemes.

During the reporting period, 50 new schemes have entered into PPF assessment. However, with an overall value of £1.7 billion, this was the highest influx in the PPF's history. Compensation payments have also increased significantly, with total payments in the year to 31 March 2018 of £725 million (up from £661 million in 2017).

Risk Reduction

Risk reduction continues to be a very important objective for trustees, with more schemes closing to future accrual and allocating a higher proportion of investments to matching assets. Employers have also increased the amount of Deficit Reduction Contributions.

Schemes also continued to take risk off the table over the year, with around £11 billion of pension liabilities transferred out of schemes, and twice that amount involved in risk transfer deals such as bulk annuities or longevity swaps.

Helpful Links:

- **PPF Purple Book**

Coming Up Next…

In 2018 this section of our Quarterly Updates often proved to be more of an exercise in parting the Brexit sea to try and identify the pensions developments that may rise to the surface in the coming months. At the time of writing, these waters are as choppy as ever, with no sign of anything non-Brexit becoming the focus of the Government in the near future.

That said, The Pensions Regulator, DWP and HMRC have continued to address the issues that exist in the pensions world and we expect to see a lot of action over the coming year, building on consultations and court judgments that arose in 2018. Some of the events we believe you should be looking out for in the next quarter are:

- In early 2019 **The Pensions Regulator is to consult on a revised DB funding Code of Practice** – this follows on from the DWP's White Paper published in 2018, which placed a focus on creating a stronger regulatory framework. TPR has stated that the revised Code will "set clearer parameters around prudent technical provisions and appropriate recovery plans within the existing scheme specific funding regime", as well as further details on how trustees and sponsoring employers will be expected to evidence the effectiveness of their funding strategies.
- 1 April 2019 is a date that **Master Trusts** in operation since prior to 1 October 2018 should be aware of. If such schemes have not at least applied for authorisation from TPR by that date, they will have to cease operating.
- As we reported in an earlier Quarterly Update, on 13 January 2019 the new governance requirements from the **IORP II Directive** came into force in UK law. While IORP II will not result in a seismic change as to how pension schemes operate, it does require a greater level of information to be made available to members, with the goal of more effective systems of governance and internal controls. TPR is due to update its Code of Practice on internal controls as a results of IORP II, but trustees should be talking to their scheme administrators now to ensure their member communications are compliant.

Coming up Next Continued…

Trustees and sponsoring employers alike should also be aware of the following key dates coming up:

- **1 February 2019** – Deadline for responses to DWP's consultation on consolidation of Defined Benefit pension schemes (so-called "superfunds").
- **5 February 2019** – The Court of Appeal will hear an appeal as to whether recovery of pension overpayments is subject to a six-year limitation period.
- **29 March 2019** – UK due to exit the EU.
- **31 March 2019** – Deadline for submission of recertified contingent assets to the PPF.
- **31 March 2019** – Deadline for applications to TPR for existing Master Trust authorisation.
- **4 April 2019** – Phase 2 of HMRC's 'Manage and Register Pension Schemes' service to come online, with scheme reporting included.
- **6 April 2019** – Auto Enrolment minimum contributions increase to 8% of qualifying earnings, with at least 3% payable by employers.
- **6 April 2019** – Lifetime Allowance limit to rise from £1,030,000 to £1,055,000 for 2019/20 tax year.

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Belfast

Linen Loft
27-37 Adelaide Street
Belfast
BT2 8FE

t: 028 9041 2000

Birmingham

Edmund House
12-22 Newhall Street
Birmingham
B3 3AS

t: 0121 389 2314

Bristol

Castlemead
Lower Castle Street
Bristol
BS1 3AG

t: 0117 959 5002

Glasgow

The Culzean Building
36 Renfield Street
Glasgow
G2 1LU

t: 0141 331 1004

Leeds

Princes Exchange
Princes Square
Leeds
LS1 4HY

t: 0113 426 4487

London

46 New Broad Street
London
EC2M 1JH

t: 020 7495 5505

Manchester

82 King Street
Manchester
M2 4WQ

t: 0161 641 6312

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