Spence & Partners – Industry Changes

Your Quarterly Pensions Update – Q1 2017

SPENCE

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Introduction

SPENCE

Welcome to your Quarterly Pensions Update.

The purpose of this report is to provide an update for pension scheme sponsors and trustees on recent industry changes, up to the end of March 2017.

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

We also include links to 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; 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.

Industry Update

Pension Protection Fund (PPF) update

Tags: PPF | PPF LEVY | SUBSTANTIVE SPONSOR | COMPENSATION CAP

There have been a number of recent developments coming from the PPF recently, as summarised below.

New compensation cap

The PPF's annual compensation cap was increased with effect from April 2017, from £37,420.42 p.a. to £38,505.61 p.a. (at age 65). This will apply to members who entered the PPF before their scheme's normal retirement age, whose benefits will be capped at 90% of this level.

Higher cap for longer serving members

From 6 April 2017 the Long Service Cap will come into effect for members who have 21 or more years' service in their pension scheme. Members who have their compensation capped will see their compensation increasing by 3% per year for each full year of pensionable service over 20 years, up to a maximum of twice the standard compensation cap.

There will be no backdating members' compensation payments. Instead, the increased cap will come into effect from the date at which the new legislation was implemented, 6 April 2017.

2017/18 PPF Levy Determination

The PPF methodology for calculating levies is fully reviewed every three years. The new levy year, 6 April 2017 to 5 April 2018, marks the final year of the PPF's second triennium. Therefore, the methodology proposed for the 2017/18 levy year is generally consistent with the 2016/17 methodology, prior to a more in-depth review next year.

The PPF published the final 2017/18 Levy Determination on 30 March 2017. The key areas where changes are being considered for 2018/19 Levy Determination onwards are regarding the impact of accounting standards changes (in particular the introduction of FRS102); a review of employer segmentation and considering the use of credit ratings and industry specific scorecards for regulated financial entities. On 23 March 2017, the PPF launched a consultation on the levy rules for the next triennium, starting in 2018. The deadline for comments is 15 May 2017.

Pension Protection Fund (PPF) update continued…

No substantive sponsor consultation

The PPF is proposing a new approach to how it would charge a levy for schemes that no longer have a substantive sponsor, perhaps as a result of scheme restructuring. This has come about as the PPF's standard approach for calculating levies is not appropriate for such schemes.

The new proposed methodology is based on a financial options pricing model, and is expected to ensure that the levies for affected schemes will be appropriate, reflecting the true risk the scheme poses.

The PPF's consultation on its proposed methodology closed on 6 March 2017. Finalised rules for calculating PPF levies for schemes with no substantive sponsor are included in 2017/18 Levy Determination, which was published on 30 March 2017.

Deadlines:

- Deficit-Reduction Contribution Certificate to be submitted on Exchange – 28/4/2017
- Certification of full block transfers to be completed on Exchange – 30/6/2017

Helpful Links:

- No substantive sponsor consultation
- New compensation cap
- Higher cap for longer serving members
- 2017/18 Levy Determination

ACTION

Scheme trustees and employers who are trying to manage their PPF levies should consider submitting a deficit reduction contribution certificate and block transfer certificate (if relevant) before the respective deadlines.

They should also consider the potential impact on their scheme of the proposed levy changes and take actions to monitor and mitigate as appropriate.

Market movements

Tags: **BREXIT | INVESTMENT | MARKET MOVEMENTS**

Following a relatively volatile second half of 2016, the major market indices have shown signs of calming down over the course of Q1 2017. The UK FTSE Actuaries' 15 Year Fixed Interest Gilt yield has remained broadly constant over the period. This stabilisation of the fixed interest gilt yield will be a welcome relief to schemes after the volatility caused by Brexit last year.

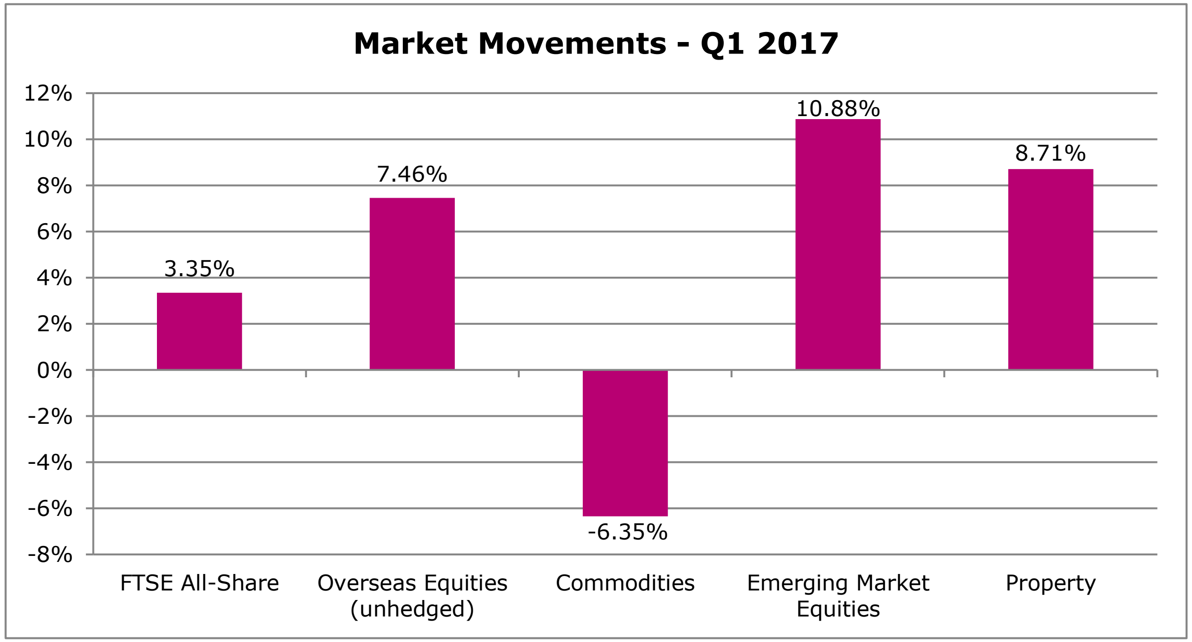
The market's implied view of the future rate of inflation has also remained broadly constant over the period. Note, however, these expectations have risen by roughly 0.5 percentage points over the last 12 months.

Similarly, the credit spread has remained broadly constant over Q1 2017. However, it has fallen by around 0.5 percentage points over the last 12 months.

Scheme liability values are largely driven by movements in gilt yields and market expectations of inflation. Given the stability in these market indicators over Q1 2017, we expect that liability values will have remained broadly unchanged all else being equal.

The graph on the next page shows how common asset classes have moved relative to their value at the beginning of Q1 2017. As you will see, out of the major asset categories only commodities have fallen in value over the quarter. Therefore, schemes that are invested in equities (both UK and overseas) will have experienced an increase in asset values. As a result, when taken together with broadly flat liability values, Q1 2017 will be broadly positive for most pension schemes.

Market movements Q1 2017 continued…



ACTION

While market movements over Q1 2017 have in general been favourable for schemes' funding levels, market volatility will continue to be a significant risk as the UK Government progresses with exiting the European Union, and with European elections looming. We encourage regular monitoring of your investments and would recommend that you put yourself in a position where you can react quickly to any sudden movements. Please do not hesitate to contact Head of Investment, Simon Cohen (Simon_Cohen@spenceandpartners.co.uk) if you would like further details about how best to do this.

BHS and British Steel cases lead to suggestions of reform

Tags: GOVERNANCE | DB | BHS | BRITISH STEEL

In 2008, the BHS Scheme disclosed a surplus. Only seven years later, in 2015, they reported a deficit of £226m. Spring forward to February 2017 and Sir Philip Green agreed a cash settlement with The Pensions Regulator ("TPR") worth £363m to plug the deficit and allow BHS workers to receive the same starting pension that they were originally promised.

Using the BHS saga as a catalyst, a December 2016 report by the Work & Pensions Committee recommends that TPR becomes empowered to impose punitive fines described as a "nuclear deterrent" on those employers seeking to avoid their responsibilities in an attempt to improve upon the retrospective punishment system in place currently. The intention is that such fines would not need to be imposed as they would act to prevent avoidance from happening.

A February 2017 report, also by the Work & Pensions Committee, put forward three recommendations for more stringent corporate governance controls following the BHS 'failures':

- Extension of the Financial Reporting Council Corporate Governance Code to cover large private companies and those with over 5,000 DB pension scheme members.
- Addition of pension scheme trustees to section 172(1) of the Companies Act 2006.
- Future Insolvency Service reports should be made available when there is significant public interest in their publication.

February also saw Tata Steel Workers voting in favour of the employer's proposal to set up an alternative DC scheme to ensure no compulsory job losses were necessary. Under the proposed changes, the British Steel Pension Scheme will close to future accrual, and be replaced with a DC scheme with maximum contributions of 10% from Tata and 6% from workers.

BHS and British Steel Sagas Lead to Suggestions of Reform continued…

Helpful Links:

- Parliamentary Committee DB Schemes Report (22 December 2016)
- Response to the Government's consultation on corporate governance reform.
- BHS trustees 'not to blame' for scheme's difficulties
- Unions urge members to back Tata Steel's plans to replace DB with DC
- Unions reluctantly back BSPS closure proposal
- Trustees must take more effective action with their investment strategies to avoid falling foul of market volatility

ACTION

Despite these high profile cases and various recommendations, nothing has really changed yet. Trustees and Employers will want to keep an eye on possible developments but for now it's business as usual. In particular, Trustees should resist the temptation to be unduly risk averse as a reaction to a couple of bad cases and Employers should recognise the need for a coherent funding strategy, even if it will take some time to come fully to fruition.

Security & sustainability of DB pension schemes

Tags: **DB SCHEMES | FUNDING | THE PENSION REGULATOR**

In February the Government released its much anticipated Green Paper seeking views from the pensions industry on the future of DB schemes. This consultation was borne out of the various high profile pension schemes that hit the media in 2016 for all the wrong reasons, and the subsequent investigations by the Work and Pensions Select Committee ("WPSC").

The reason for the consultation was initially a concern that DB schemes in general were broken and the entire mechanics of the DB regime needed a service – or perhaps a full re-build – to address the issues from BHS (and others), and find out if those issues were a rust on the whole industry.

However, as it turned out the Government took the initial findings of the WPSC and spelt out their conclusions on DB schemes in the Green Paper, before asking for the industry's opinions. For instance, the Green Paper states that there isn't a "significant structural problem" with the regulatory framework and that in general deficit reduction contributions are not driving employers to insolvency, contrary to perceptions.

So, given the approach taken by the Government in the Green Paper, it is difficult to see how it might result in a full re-build of the DB pension vehicles (to continue the earlier car analogy!). This consultation is more likely to result in a re-tune, with the following areas of particular interest to the Government:

1. **Funding and Investment –** Should the Regulator be more proactive in regard to funding and investment decisions? Is there too much risk-aversion in the industry?

2. **Employer Contributions –** Focus on how to identify and assist "stressed employers", including the most controversial suggestion in the Green Paper, of allowing all schemes to switch to CPI indexation and revaluation, or even to amend accrued benefits.

3. **Member Protection –** Measures to increase the powers of the Regulator and ensure better communications with scheme members on key decisions.

4. **Consolidation of Schemes –** Should the Government encourage (or even force) struggling schemes to consolidate to increase efficiency?

Security & sustainability of DB pension schemes continued…

Helpful Links:

- Consultation Document: https://www.gov.uk/government/consultations/defined-benefit-pension-schemes-security-and-sustainability

ACTION

Spence will be submitting a response to the consultation, which we will expand on in the next Quarterly Update. For now, there is no immediate action but interested trustees and employers may wish to review the topics raised in the Green Paper and consider how their current scheme governance and risk management processes could be affected by the proposals. If you wish to submit your own views, the deadline for responding to the consultation is 14 May.

Survivors' pensions – unmarried couples and equal treatment

Tags: ADMINISTRATION | SCHEME GOVERNANCE | SCHEME RULES | DISCRIMINATION

In February 2017 the Supreme Court ruled on a case that was originally argued before the Northern Ireland High Court in 2012, but in truth this case began in 2009 out of tragic circumstances. Ms Brewster was the cohabiting partner of Mr McMullan, who was a member of the Local Government Pension Scheme Northern Ireland ("the Scheme") for some 15 years. After ten years living together, in 2009, only two days after getting engaged, Mr McMullan sadly passed away.

Under the rules of the Scheme cohabiting surviving partners like Ms McMullan were entitled to a survivor's pension, if evidence of their cohabitation was provided by the member, as well as a nomination form. Mr McMullan had not submitted a nomination form, so Ms Brewster was not awarded a survivor's pension.

Taking her case to the Supreme Court over a five year period, Ms Brewster was ultimately afforded with a positive ruling, delivered by the former Lord Chief Justice of Northern Ireland, Lord Kerr. In a unanimous decision the Lords held that "the procedural requirements to establish a genuine… relationship existed" were understandable, but that the additional need for a nomination form had "no inherent value" and was unlawful discrimination and a breach of Ms Brewster's rights under the European Convention on Human Rights.

In a wider context, Ms Brewster's case could be made more significant by the pending Supreme Court decisions of O'Brien v the Ministry of Justice and Walker v Innospec. Those cases will decide whether non-discrimination legislation – as applied in Brewster – could retrospectively change the pension entitlement of members. If those appeals succeed, pension entitlement for surviving partners could be retrospectively applied to pension built up before the anti-discrimination laws even came into force – needless to say, this could have a significant impact on scheme liabilities. So, look out for our next Quarterly Update, which will (hopefully) have a summary of the O'Brien and Walker decisions!

Survivor's pensions – unmarried couples and equal treatment continued…

Helpful Links:

- Case Report: http://www.bailii.org/uk/cases/UKSC/2017/8.html

ACTION

Public sector schemes in particular should be looking to amend their rules if they have a similar nomination form requirement.

All pension scheme trustees should also be looking at their own procedures for survivor benefits. If a scheme's rules include any procedural requirements for unmarried couples that do not exist for married members, this should be a red flag for trustees to ask themselves if those additional steps are reasonable, or an unnecessary stumbling block.

Pensions scams consultation

Tags: PENSION SCAMS | GOVERNANCE | FUNDING

In 2016’s Autumn Statement the Chancellor announced that the Government would be consulting on a ban on cold calling and other measures to protect consumers from pension scams.

That consultation was issued shortly after the Autumn Statement and responses were to be submitted by 13 January 2017.

The consultation set out a package of measures aimed at tackling three different areas of pension scams:

- A cold calling ban aimed at cutting off a key source of pension scams whilst also sending a clear message to consumers that they should hang-up if they are cold called about their pension.
- Current legislation gives pension schemes limited scope to refuse a transfer to a scheme which looks like a scam, even if they have legitimate concerns as to the safety of a member’s savings. The Government was consulting on clarifying the law so that firms can block pension transfers based on clear objective criteria
- Single-member occupation pension schemes currently require no registration with The Pensions Regulator, and can be set up using a dormant company as the sponsoring employer. They are therefore an easy way for fraudsters to register a pension scheme with HMRC. The government were consulting on making it a requirement that only active companies can register a pension scheme.

Spence very much welcomed the consultation and provided a full response. The Government’s findings are expected in Spring 2017.

Time to review your actuarial valuation assumptions?

Tags: DEFINED BENEFIT | PENSIONS | ACTUARIAL

After a turbulent few years, many defined benefit pension schemes are approaching the date at which they (once every three years) formally assess their scheme's funding position. One of the main actions for trustees and sponsoring companies is to set the actuarial assumptions which drive the value of the scheme's liabilities. The value of the liabilities will in turn determine the reported deficit position and the level of future contributions required.

Each scheme will now have had several valuations under the current funding regime. So, it would perhaps be tempting just to follow the same method as before and accept whatever results come about. Given changes to market conditions over the last few years, this may not be the right thing to do.

For the first time in many years, there is a serious debate about the right approach to setting assumptions. Many argue that pension schemes have been overly prudent (by assuming liability values are tied to long-term government bond rates and investing accordingly) and that it would be more appropriate to invest in growth seeking assets such as equities and calculate lower liabilities valued based on higher expected future investment returns. The Pensions Regulator is also keen that trustees and sponsors use the flexibility available in the funding regime.

The value of a scheme's liabilities is very sensitive to small changes in the underlying actuarial assumptions. For example, a 1% a year change in assumed investment return for a typical £100m scheme would put the value of the liabilities up or down by around £20m.

In contrast to previous projected trends, future life expectancy has also decreased. A 1 year change in assumed life expectancy for members would alter liability values for the same example scheme by around £4m.

It is worth remembering though that assumptions are just that – actual experience not assumptions will determine the true cost of pension schemes.

Trustees have a very difficult balancing act. If they make assumptions that don't come off, then higher contributions will be required to plug the deficit in future. However, if they demand too high a level of contributions up-front, the sponsor may struggle to meet them or struggle to maintain the profitability required to stand behind the scheme over the long-term.

Time to review your actuarial valuation assumptions continued...

Helpful Links:

- TPR Code of Practice 03
- Hugh Nolan's review on tPR Funding Statement

ACTION

Trustees and Companies to:

- Consider alternative approaches
- Understand the sensitivity of your scheme's liabilities to changes in assumptions
- Review your investment strategy to ensure compatibility with the approach on funding
- Examine the affordability of sponsor contributions under various scenarios
- Ensure collaborative and open dialogue from the outset

High Transfer Values. High time to cut back? High time to de-risk?

Tags: TRANSFER VALUES | BREXIT | FUNDING | LIABILITY MANAGEMENT

Transfer Values ("TVs") have been steadily increasing over the past few years. TVs are typically calculated with reference to gilt yields – the higher the gilt yield the lower the TV and vice versa. Gilt yields have been steadily getting lower and lower. For example, the annualised yield on the FTSE Actuaries 15 Years Fixed Interest gilt index was 1.6% p.a. as at 1 March 2017, compared to 2.22% p.a. as at the same date two years ago (and 3.2% p.a. the year before that).

As well as this, inflationary pressures are on the rise. The market's expectation of future inflation has increased by around half a percent per annum over the last couple of years. As the majority of pensions have some form of inflation-linkage this also pushes up the value placed on TVs.

From a member perspective, TVs can appear very attractive. Freedom and Choice in Pensions means that following a transfer to a Defined Contribution scheme members can take their entire fund as cash or draw down an income over time. As such, the number of Defined Benefit members seeking transfer quotations has increased dramatically. When considering a transfer, the Financial Conduct Authority states that the default starting position should be to assume that a 'transfer is not in the member's best interests'. However sometimes it is, for example if the member has a short life expectancy, is unmarried and does not have dependants, prefers wealth to income, or would like to leave money to dependants on death.

What does this mean?

What does this mean for Trustees of pension schemes? The pensions landscape has changed, and Trustees should ensure that members are aware of all of their options at retirement. Some trustees are concerned about the risk of recourse if a member makes the wrong choice due to lack of information.

Rising TVs, coupled with Freedom and Choice in Pensions, means that more members are likely to request transfers out of their respective pension schemes. Trustees may consider commissioning an Insufficiency Report if the funding position of the Scheme would be adversely affected by a high number of transfer values. Conversely, the release of reserve that is obtained when members transfer their benefits out may be a welcome improvement.

High TVs. High time to cut back? High time to de-risk? Continued...

Employers may look to these times as an opportunity to carry out transfer exercises – offering members the option to transfer out of their pension scheme to an alternative arrangement. With TVs as high as they are, the cost of carrying out these exercise is significantly lower as employer 'top-ups' do not need to be as high as in previous years.

ACTION

- Trustees should consider current administration processes to ensure that members are aware of all options at retirement.
- Trustees should also consider commissioning an insufficiency report if transfer value requests increase and this is expected to adversely affect funding.
- Sponsors should consider their long term objectives and whether or not a transfer exercise would be appropriate in the current climate.

Auto-enrolment – new earnings band for 2017/18

Tags: AUTO ENROLMENT | DEFINED CONTRIBUTION

A statutory instrument has been approved by Parliament revising the auto-enrolment qualifying earnings band for the 2017/18 tax year. This came into force from 6 April 2017.

The key figures for the 2017/18 tax year are:

- The upper end of the qualifying earnings band will rise from £43,000 to £45,000, in line with the revised upper earnings limit for National Insurance contribution (NIC) purposes.
- The lower end of the band will rise from £5,824 to £5,876, again in line with the NIC lower earnings limit for 2017/18.

The order does not make any changes to the earnings trigger for auto-enrolment, which will remain fixed at £10,000 for 2017/18.

Employers will need to ensure contributions calculated after these dates are paid based on the revised bandings. In addition, the adjustment to the lower band may lead to an increase in the number of Entitled Workers caught by this legislation.

The minimum levels of contributions remain at 1% for employees and employer until 5 April 2018. The DWP will conduct a further review during 2017, and more details may follow.

Helpful Links:

- Automatic enrolment earnings threshold

ACTION

Employers to ensure correct level of contributions are paid allowing for the new earnings band. Employers should also review their covered workforce in line with the revised bandings.

GMP equalisation – the saga continues

Tags: **GMP | CONTRACTING-OUT | ADMINISTRATION**

Late last year, the Government consulted on a method to equalise guaranteed minimum pensions ("GMP") – a topic that has seemingly been in its "too difficult" box for many years, or even decades. The proposed method was broadly welcomed by respondents to the consultation, who felt it was a "distinct improvement" on the previous 2012 consultation.

The proposed method is to look at the member's pension built up during the GMP accrual period (i.e. between 1978 and 1997) and work out what the value of this would be under two scenarios:

1. If the member is a man or a woman; and

2. The benefits are then converted into a non-GMP pension - which is valued at the higher of those two amounts.

In essence, this seems to be a fairly simple conversion calculation, but in reality there are many complexities to overcome, including data availability and the resolution of various actuarial and legal issues. The consultation process uncovered a number of technical points, which the Government is now considering in tandem with an industry working group. At the moment, there is no timeframe for when the method will be finalised or when required legislative changes (if any) may be implemented.

A separate but related issue is that several technical changes to contracting-out regulations have recently been finalised. Amongst other things, these regulations revise the rate of fixed-rate GMP revaluation for those leaving pensionable service after 5 April 2017. This rate has been set at 3.5% p.a. year – a reduction from the current 4.75% rate – and will come into force from 6 April 2017.

GMP equalisation – the saga continues, continued…

Helpful Links:

- [What's left to do on GMP equalisation.]

ACTION

Where relevant, trustees should amend their administration routines to allow for the new fixed rate revaluation percentage.

Regardless of when or whether any equalisation methodology is finalised, there are a number of actions that trustees can and should be looking at, which will impact positively on any future GMP equalisation exercise, but also yield positive standalone benefits. These include:

- Complete the GMP reconciliation before HMRC support is withdrawn at the end of 2017;
- Complete any other data or benefit rectification projects;
- Review the scheme's equal treatment solution against current legal requirements.

These are all actions that will be required at some point in a scheme's life. By completing them now, trustees will save themselves time and money down the line.

Coming up next...

Although you'd have been forgiven for thinking that the triggering of Article 50 and the start of negotiations with the EU on Brexit would have taken their focus, the Government is still spending time on the pensions industry, with the following on the horizon in the next quarter:

- **Green Paper on DB Pension Schemes** – as mentioned earlier, the closing date for the consultation is 14 May 2017. We at Spence will be submitting our views and the next Quarterly Update will include what we told the Government.

- The Supreme Court decisions in **O'Brien and Walker v Innospec** are expected in the coming months, which will decide whether pension entitlement may be changed retrospectively for discriminatory conduct. If this is allowed it could be hugely significant, so these are rulings we'll be keeping a keen eye out for.

- **The Finance Bill 2017** includes changes to the money purchase annual allowance and the introduction of a new charge on overseas transfers. The second reading of the bill is due on 18 April 2017, so the next Quarter should bring more clarity on how these changes will need to be implemented.

- We also expect to see in April or May the Government's response to the recent pension **cold-calling consultation**. Let's see if any of Spence's ideas/comments were taken on board.

Key dates:

- **28 April 2017** – Date for submitting Deficit Reduction Certificates to the PPF. If your scheme receives deficit reduction contributions, get in touch with your advisors right away to see if submitting a certificate would produce a saving the scheme's PPF Levy.

- **9 May 2017** – The Regulator's Professional Trustee consultation closes for responses;

- **15 May 2017** – The consultation on the third PPF Levy triennium closes.

- **1 May 2017 to 1 February 2018** – Staging dates for new employers paying PAYE income for the first time from 1 April 2012 to 30 September 2017. Relevant new employers should check their staging date at the Pension Regulator website (http://www.thepensionsregulator.gov.uk/checking-your-clients-staging-date.aspx).

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