

Pensions Digest

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Coalition Government hammers out its pensions policies

Pension issues appear frequently in the policy document published by the coalition Government of Conservatives and Liberal Democrats. However, the agreement might be as significant for what it does not say as for what it does: no mention is made of the Liberal Democrat proposal to restrict tax relief on pension contributions to the basic rate, suggesting that higher rate relief might be safe for now. The commitments that are made cover the default retirement age, the State Pension Age (SPA), earnings indexation of the Basic State Pension (BSP) and annuity reform.

The Department for Work and Pensions (DWP) also has the potential to be a bellwether for the coalition government's 'new kind' of collaborative politics. Former Conservative leader Iain Duncan Smith, seen as being on the right of the party, is to be Secretary of State, assisted by new Pensions Minister Steve Webb, seen as being on the left of the Liberal Democrats.

Tax relief

The Liberal Democrat manifesto proposed restricting tax relief on pension contributions to the basic rate to help pay for a higher personal allowance. In practice, this would have meant levying a 20% tax charge on the money that higher rate taxpayers or their employers pay into pensions. The agreement lists other measures which will be used to pay for a higher personal allowance, such as increases in capital gains tax, but does not say that abolition of higher rate tax relief is under consideration. Having spent 13 years attacking Gordon Brown for taxing pensions in his first Budget, it would have been very hard for George Osborne to do the same thing in his!

However, the restriction of tax relief for people with incomes above £130,000 looks set to go ahead: both parties voted for that legislation and David Cameron said during the campaign that it was not something he could afford to reverse. The question now is whether more people will get sucked into the net each year if the thresholds are not indexed.

Default retirement age

The policy agreement says: "The parties agree to phase out the default retirement age...". While this is a small concession to the Liberal Democrats, it is a move which the Conservatives had been leaning towards themselves. However, it remains unclear how quickly it will be phased out and whether an increase in the age might precede outright abolition.

The pressure for such a measure has been building as baby-boomers approach retirement, but implementing it will bring some practical difficulties for companies if they offer benefits like life insurance and health insurance which providers may not supply for all employees regardless of age.

Relaxation on annuity purchase

Both coalition parties had similar policies on ending the rules requiring annuitisation at 75. Although most people who are responsible enough to have saved in the first place will be careful in retirement, the parties are alive to the danger of 'double-dipping'—spending your pension savings and then falling back on means-tested benefits. Drawing up rules to prevent this will not be straightforward.

The Government has said it will explore the potential to give people greater flexibility in accessing part of their personal pension fund early. Together with annuity reform, such a change could lead to the justification for tax-privileged pension savings being queried in future.

“...a ‘triple guarantee’ that pensions are raised by the higher of earnings, prices or 2.5%...”

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Towers Watson

Towers Perrin and Watson Wyatt have come together as Towers Watson – a global company that shares a common set of values and a singular focus: our clients. This fourth edition of *Pensions Digest* brings together recent pension developments previously brought to you by Towers Perrin's *Monitor* and Watson Wyatt's *Pensions News Filter*.

State pensions – early earnings link

The coalition has said it “will restore the earnings link for the basic State pension from April 2011 with a ‘triple guarantee’ that pensions are raised by the higher of earnings, prices or 2.5%, as proposed by the Liberal Democrats.”

During the election campaign, the Conservatives committed to restoring the earnings link in 2012. With price inflation high and earnings growth subdued, doing it a year earlier is likely to have little or no extra cost. By ruling out the option to delay the earnings link until 2015 the Conservatives had already removed the little fiscal leeway they had. It is also hard to believe that a future government would actually have increased pensions by less than inflation in the rare circumstances when the legislation permitted, so the ‘triple lock’ reflects what would probably have happened in practice anyway.

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State Pension Age

The agreement also says: “The parties agree to... hold a review to set the date at which the State Pension Age starts to rise to 66, although it will not be sooner than 2016 for men and 2020 for women.”

Currently, the SPA is set to rise from 65 to 66 between 2024 and 2026. Since this timetable was set out, average life expectancy as shown by official projections has risen by almost two years – so even people made to wait a year longer to claim their State pensions may receive them for longer. As important as when the SPA rises to 66 is when it rises to 67 and beyond, so we expect the review to cover that as well.

Pre-election, the Conservatives said this was the tough choice which made their promise to restore the earnings link credible. However, the deterioration of the public finances and improvements to life expectancy both make the current system appear less affordable than when Parliament implemented the main recommendations of the Pensions Commission in 2007. While there is a strong commitment to the earnings link for the BSP, it remains possible that the coalition will look for other ways of making State pensions less expensive in future than they are currently expected to be.

For their part, the Liberal Democrats had called the suggestion that the SPA should rise more quickly an “attack on the state pension” which would turn retirement planning “upside down”. However, this

is an area where politicians are used to performing U-turns even when they do not have to compromise with each other: all three parties supported a higher SPA in the last Parliament without saying they would do so before the election.

Public sector pensions

The coalition brings together two parties who had entered the election campaign indicating that they would reform pensions for public sector employees without being clear as to how. Initially, this question will be referred to an independent body with the agreement saying: “The parties commit to establishing an independent commission to review the long-term affordability of public sector pensions, while protecting accrued rights.”

2012 reforms

Both parties supported legislation requiring automatic enrolment of employees into pension schemes with employer contributions. The coalition’s policy document states that the Government “will work with business and the industry to support auto-enrolment”. However, the government has indicated a contract for the supply of administrative services to the National Employment Savings Trust will be reviewed as part of a general re-examination of spending commitments entered into since the start of 2010.

New Pensions Minister, Steve Webb, has previously queried the decision to phase in the minimum contribution rates and to deduct even minimal contributions of a few pence a week from people’s pay packets. However, that does not necessarily mean these things will change, especially as the phasing in of contributions is currently required by primary legislation.

And finally, the coalition agreement invokes a sense of *deja vu* by announcing an intention to “simplify the rules and regulations relating to pensions to help reinvigorate occupational pensions.” While the weight of regulation is undeniably onerous, we have seen exercises such as this founder in the past once the implications of the deregulation become apparent.

Europe matters (more than you might think)

A new European supervisory body may have the power to impose funding standards on occupational pension schemes, if proposals working their way through the European Commission (EC) take effect. Irrespective of this, a review of the existing Pensions (also known as IORP) Directive seems to be nudging towards some harmonisation of

solvency standards for pension funds across Europe. For good measure, the EC is due to launch a high-level consultation (Green Paper) targeting delivery of adequate and sustainable pensions.

Financial oversight

In October 2009 the EC adopted draft legislation intended to strengthen the supervision of the European financial sector by creating a new supervisory framework. A new body: the European Insurance and Occupational Pensions Authority (EIOPA), will replace the current Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and is intended to be operational from 1 January 2011.

EIOPA will take on the existing role of CEIOPS, but with additional powers, some of which may impact directly on UK occupational pension schemes. EIOPA is likely to set a common standard in relation to the information that a pension fund has to provide to its supervisory authority (the Pensions Regulator, within the UK). Whether, or how far, this might go beyond existing UK requirements is unclear.

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More worrying are proposals that EIOPA should “ensure that the same technical rules are applied and enforced consistently across the EU” – potentially allowing EIOPA to set funding standards with only minimal scrutiny. These proposals, which are currently being considered, are in addition to changes proposed that might flow from a review of the Pensions Directive, which is covered below.

Green Paper

We expect the EC to publish a short, high-level consultation (Green Paper) in June 2010. Through this, it will consult on whether it is necessary to update EC legislation, regulation and coordination to safeguard European pension systems. The Commission’s aim is to consult stakeholders, asking open questions on how the EU framework for pensions should be updated to support Member State efforts to achieve adequate and sustainable pensions. It will take stock of existing EC regulation and policy coordination as well as the outcome of previous reforms. Both State and all forms of supplementary pension provision will be considered.

The Green Paper may lead to further consultation (a White Paper) on how to address issues identified, but this is unlikely to take place until 2011.

EC review of the Pensions Directive

At the same time as the above developments, the EC is formally reviewing the Pensions Directive, which led to the introduction of scheme specific funding in the UK. While it might be easy, tempting even, to dismiss this as an academic exercise, there seems a momentum within the EC for common solvency standards for pension schemes. Although it remains unlikely that (unmodified) Solvency II standards will be forced upon on schemes, some harmonisation seems likely. This could include a common basis for valuing a sponsor covenant.

The Commission’s starting premise is that all financial institutions (including pension funds) should hold capital adequate to cover their risks, although it does recognise that there are differences between insurance companies and pension funds in the underlying risks and the duration of liabilities.

IAS 19 proposals to increase the reported cost of pensions

The International Accounting Standards Board (IASB) exposure draft of changes to the accounting standard IAS 19 attempts to increase the consistency of pensions accounting between companies. The changes are the outcome of IASB’s scaled-back ‘phase 1’ review which is intended to improve the consistency in how the standard is applied. Many companies reporting under IAS 19 could see an increase in both the annual pensions cost recognised in profit and loss and the pension liability shown on the balance sheet. If adopted as proposed then:

- The expected rate of return on assets will be replaced by the corporate bond-based discount rate, removing a source of profit for schemes with appreciable return-seeking holdings.
- Expected future operating costs, potentially including future Pension Protection Fund levies, will need to be capitalised and added onto the accrued pension liability.
- Career average plans and some cash balance plans may need to recognise a higher cost of accrual and balance sheet liability.

The exposure draft narrows down the options in accounting for pension cost, including:

- Removing the corridor approach whereby gains and losses of up to 10% of the plan can be kept off the balance sheet indefinitely with the remainder spread over several years. Immediate recognition of all gains and losses will be required for both assets and liabilities.
- Prescribing which lines in the profit and loss account should be used for each item of pension cost.

By taking away the guaranteed accounting 'profit' from holding equities and ending the smoothing effect of the corridor, the revised IAS 19 may cause companies to question why they are running significant investment risks in their pension plans at all. There is a separate IASB proposal to present a single statement of comprehensive income, which may add further incentive for companies to prioritise reducing short-term volatility in preference to a longer-term asset strategy.

The exposure draft also contains proposals to expand the disclosure requirements. Information would need to be provided on the risks of

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sponsoring a defined benefit pension scheme, the sensitivity of the pension liability to changes in actuarial assumptions and the approach used to select demographic assumptions.

IASB is consulting on the exposure draft until 6 September. Changes to IAS 19 will be confirmed in mid-2011 and are expected to apply to financial years starting on or after 1 January 2013. Comparative figures will need to be restated to comply with the revised standard.

If all goes to plan then IASB could begin work on a more fundamental 'phase 2' review towards the end of 2011. This would be on the expectation of convergence with the corresponding US accounting standards.

Surplus payments – last chance saloon

The Pensions Act 2004 includes a provision entitled “Payment of Surplus to Employer – transitional power to amend scheme”. An

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innocuous enough title which, in keeping with the genre of such provisions, appears to be giving trustees a bridging tool to help them transition through legal changes wrought – in this instance – by the Finance and Pensions Acts 2004. However, first impressions can be deceptive and this case does not disprove the rule.

Certain ongoing pension schemes (and possibly schemes in wind up) wishing to retain an existing power to refund surplus to the employer will need to take action before 6 April 2011, if this power is not to be lost. The Pensions Act 2004 provides that any existing power to refund surplus in place on 5 April 2006 cannot be used after this date unless trustees pass a resolution preserving the power either in its existing or modified form. However, trustees are required to pass the resolution in accordance with the power under the Act and this has a shelf life which expires on 5 April 2011. Consequently, it appears that by missing the deadline, schemes could lose the power to make refunds after this date. Representations have been made to the DWP requesting removal of the deadline but it has still to respond.

The schemes affected are those which had not commenced winding up on 5 April 2006 and whose rules on that date contained a power permitting refunds of surplus to the employer. Unfortunately, the way the legislation is worded, it seems that the general prohibition may extend to refunds of surplus on winding up as well as from ongoing schemes. Whether this was the policy intention is unclear and legal opinion is divided as to whether a narrower interpretation is sustainable.

This issue will be of interest to employers as well as trustees who will wish to ensure that their schemes retain the power to make refunds for the following reasons:

- If a pension scheme cannot pay a refund to the employer then, under IFRIC 14, the employer may need to limit the asset it can show on its balance sheet. This is the case even though the scheme is more than 100% funded against its obligations as measured by IAS 19. Furthermore, if the scheme is targeting a higher cash funding level than 100% of the IAS 19 obligations, then the difference may also make its way on to the employer's balance sheet as an additional liability.

- Employers will be reluctant to agree to funding levels which could result in surplus monies being trapped in the scheme whether on winding up or otherwise.

Trustees are permitted only one resolution and this must be passed no later than 5 April 2011. However, before this can happen, trustees must be satisfied that passing the resolution is in the interests of the members. Furthermore, members must be notified in writing about the trustees' intention to reactivate their power to refund surplus to the employer. The notification must include the date from which the power will take effect, which cannot be less than three months after the information was provided to members. Affected trustees should be aiming to issue member notifications before Christmas 2010 to ensure the 2011 deadline is not missed through procedural delay.

Pensions roundabout

Putting the house in order

Two consultation exercises from the Pensions Regulator have recently closed. These concern record-keeping and avoiding delays in winding up. Both are themes to which the Regulator is returning, with the latest versions indicating that its patience is wearing rather thin.

“Both of these consultation documents raise the prospect of enforcement powers being used unless significant progress is made voluntarily...”

To date the approach has been educative and focused on providing helpful guidance as to what the Regulator considers to be best practice. Both of these consultation documents raise the prospect of enforcement powers being used unless significant progress is made voluntarily and is seen to be made.

Our responses to these consultations acknowledged the desirability of the stated aims, but urged the Regulator to maintain a flexible and proportionate approach to enforcement action.

Equality Act 2010

The Equality Act 2010 received Royal Assent on 8 April 2010 and harmonises and in some cases extends anti-discrimination law covering the 'protected characteristics' of age, disability, gender reassignment, marriage and civil

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partnership, pregnancy and maternity, race, religion or belief, sex, and sexual orientation.

The Act also extends age discrimination provisions outside the workplace and allows ministers to introduce regulations imposing a duty on employers with more than 250 employees to review gender pay differences within their organisations and publish the results. It also makes allowance for a minister to amend UK equality legislation to comply with European law without the need for primary legislation. Most of the provisions are not expected to come into force until October 2010. However, the age discrimination provisions may not come into force until later.

Employer Financial Promotions – exemption extended

Regulations, which came into force on 13 April 2010, exempt employer financial promotions in relation to a greater range of products offered to staff such as life assurance and long-term disability insurance among others. Previously, the exemption covered only pension products. Corresponding exemptions will also apply in respect of financial promotions made by third parties on behalf of the employer in respect of the same range of products. The exemptions mean that qualifying financial promotions by employers (or third parties on behalf of employers) do not need to be approved by a person authorised by the Financial Services Authority if certain conditions are satisfied – including that the employer has not and will not receive(d) any 'direct financial benefit'.

Equalisation – scheme amendments

The Court of Session in Scotland has ruled in the case of Low & Bonar PLC versus Mercer Limited that board minutes of the scheme's principal employer and trustees, purporting to equalise normal pension ages for male and female members from 1 July 1991, constituted a 'deed' for the purpose of the scheme's amendment power.

(The amendment rule of the Low & Bonar Group Retirement Benefit Scheme required changes to be made by deed.) So, even though a deed formally amending scheme rules was not made until 15 August 2002, equalisation was effective from 1991.

Generally, Scottish law allows a wide interpretation of what constitutes a deed provided the requirements of formality and legal relations are

met. A narrower interpretation is applied under English law where courts have ruled in a number of cases that equalisation was ineffective from the intended date because documentation purporting to make the change (for example, trustee minutes and member announcements) did not constitute a deed as required by scheme rules.

Further information

For further information, please call your Towers Watson consultant. Alternatively, you can contact

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