

Pensions Digest

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Switch to CPI for pensions indexation and revaluation

Minimum increases to occupational pensions will be switched to the Consumer Prices Index (CPI) from the Retail Prices Index (RPI) following an announcement by the Minister for Pensions on 8 July. The Minister's statement follows the Chancellor of the Exchequer's Budget announcement that public service pensions and State benefits would in future be increased in line with CPI.

The effect depends on the precise terms of the scheme rules and the exact details of any legislative changes when finalised and is unlikely to impact all schemes in the same way. For schemes that are affected, the change is likely to result in lower benefits for members and consequently to reduce the liabilities both at funding valuations and in company accounts, and to reduce transfer values. The Minister's statement indicated four areas in which changes would occur:

- The next Revaluation Order, which will be effective from January 2011, setting out the minimum revaluation in deferment for final salary schemes will be based on changes in the CPI in the 12-month period to 30 September 2010.
- The Revaluation Order also determines the increase to post-1997 pensions in payment for those schemes using the 'default' basis under the legislation rather than a scheme-specific basis.
- The CPI will similarly be the basis used for determining the in-payment increase in April 2011 for Guaranteed Minimum Pensions accrued between 1988 and 1997.
- The relevant legislation will be amended so that increases to benefits payable under the Pension Protection Fund (PPF) and Financial Assistance Scheme are linked to the CPI.

This does not mean that **all** pension scheme benefits will necessarily move to a CPI increase basis. Although the subsequently-issued press release confirms that other references in legislation will be changed from RPI to CPI as soon as possible, it does not explicitly cover what the Government intends to happen for the many occupational schemes that use their own RPI-linked basis (rather than the legislative default) to comply with the statutory requirements on increases to

pensions in payment. A particular issue for schemes which have rules specifically referring to the RPI is that, under current legislation, it is not likely to be possible to switch to CPI for benefits in respect of past service. It is unclear if the Government will override scheme rules to allow these schemes to benefit from the change.

The general expectation is that CPI increases will normally be lower than RPI increases, with the difference having averaged around 0.75% per annum over the past 10 years. This partly reflects a different methodology for calculating the index, and partly reflects differences in the goods and services covered, especially housing.

Statement by the Regulator

A subsequent announcement from the Pensions Regulator has sought to assist trustees in managing these changes by urging them to open dialogue with their sponsoring employers, to review scheme rules and to consider expectations around indexation as set out in member communications. One area of potential difficulty concerns taking into account CPI when carrying out funding valuations and setting schedules of contributions and recovery plans. The statement says "the Regulator will continue to assess recovery plans on the current basis", indicating that it does not believe that schemes should take advantage of the change with immediate effect. It adds that, should the change lead to lower liabilities in the future, it would expect to see this reflected in shorter recovery plans.

The Regulator says that it will provide further guidance once the legislative provisions have been finalised. In the meantime, please contact your usual Towers Watson consultant to consider how the changes will impact on your scheme.

Flexible use of DC funds

The Government has published a consultation paper on proposals to remove the requirement to purchase an annuity by age 75 and, in certain circumstances, to allow individuals to take more of their pension savings as a lump sum. From April 2011 the measures will enable individuals with defined contribution (DC) funds to:

- Defer purchasing an annuity or securing income indefinitely.

In this issue

- 1 Switch to CPI for pensions indexation and revaluation
- 1 Flexible use of DC funds
- 2 Revisions to transfer incentive guidance
- 3 Pensions Regulator consults on multi-employer schemes guidance
- 3 Next steps on auto-enrolment and increasing State Pension Age
- 4 Green Paper opens up debate on solvency measures
- 4 Pensions roundabout
A summary of other developments relating to pensions

- Withdraw funds either on a capped basis or an unlimited basis, subject to having first secured a “minimum income”.
- Receive a pension commencement lump sum beyond age 75.
- Provide a lump sum death benefit on death beyond age 75, subject to a tax charge.

Under the proposals individuals with money purchase funds will no longer be required to secure pension income on reaching age 75. This will give individuals who wish to buy an annuity greater flexibility over the timing of its purchase. Income drawdown will continue to be available from age 55 and there will be two variants – a capped and an unlimited basis. The capped basis will limit the maximum income that can be drawn each year (there will be no minimum income requirement). Currently, the maximum income that can be drawn before age 75 is 120% of the value of the equivalent annuity. The Government is asking for views as to whether this maximum level remains appropriate from April 2011.

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The unlimited basis is a more flexible form of income drawdown that will allow all of a person’s DC funds to be drawn as a lump sum, provided that they can demonstrate that they have already secured income that meets the “minimum income requirement” (MIR). The level of the MIR has yet to be set, but its purpose is to ensure that a person does not exhaust their savings prematurely and then call upon State support. Secured pension income must take the form of a pension already in payment, which is guaranteed for life and which makes allowance for “reasonable expectations of the future cost of living”. State pension benefits in payment may also be taken into account. In determining the appropriate level for the MIR, consideration will be given as to whether it is based on an individual’s age and marital status. Once in place, the MIR level will be subject to review.

The tax-free pension commencement lump sum will continue to be available when funds are put into payment – from age 55 through until death – meaning that up to 25% of any capital withdrawn will be tax-free; any balance drawn will be taxed as income. Unused funds on death will be subject to a recovery charge of around 55% on death on or after age 75. Lump-sum death benefits payable before age 75 (where attributable to funds not already in payment) will remain tax free within the individual’s lifetime allowance. The requirement remains to test an individual’s pension savings against their lifetime allowance at age 75 (or earlier crystallisation). Inheritance tax will not normally apply to unused pension funds remaining after death in addition to the recovery charge. However, the Government will

keep this under review and take further action if there is evidence that the new rules are being used for the purpose of reducing inheritance tax liabilities.

The consultation ends on 10 September 2010. Draft legislation will be published in autumn 2010, for inclusion in Finance Bill 2011.

Reduced annual allowance

At the time of going to press an announcement containing policy details on the tax regime for high earners was expected towards the end of July. We expect this to confirm the implementation of a reduced annual allowance instead of the high income excess relief charge. Towers Watson’s Hot Topics service will carry more details of this development.

Revisions to transfer incentive guidance

The Pensions Regulator has issued new guidance on transfer incentives for consultation in conjunction with a joint statement from the Regulator and the Financial Services Authority (FSA). Both bodies are concerned that pension transfers are a complex area and that some transfer exercises are not being conducted in a manner that enables members to make a fully informed choice.

The Regulator’s draft guidance sets out five ‘principles’ employers are expected to follow if offering transfer incentives or pension increase exchanges:

- Members should be provided with information that is clear, fair and not misleading.
- The offer should be open and transparent with the reasons for the exercise made clear.
- Conflicts of interest should be identified and appropriately managed and, if necessary, removed.
- Trustees should be consulted throughout the process with their concerns alleviated before the exercise continues.
- Fully independent and impartial financial advice should be made available to all members who should be strongly encouraged to take advice before reaching a decision.

If parties adhere to these principles then the Regulator “expects that any member will be given all the information they need to understand the implications of accepting the offer, and will be able to make the right choices for their own specific circumstances”. Despite this, the Regulator believes accepting a transfer incentive will be in the interests only of a minority, and states that trustees should start from the presumption that the exercises themselves are not in members’ interests.

The joint statement with the FSA stresses concerns about the quality of advice being given to members.

It states that “when a firm advises a scheme member to transfer their pension benefits to another scheme, it must take reasonable steps to ensure that the personal recommendation is suitable for that member in light of their personal and financial circumstances”. This must look beyond simple “critical yield” assessments.

The joint statement also emphasises the importance of identifying and managing conflicts of interest, and states that the members’ advisers should be different from those advising the employer.

The consultation runs until 5 October 2010. Towers Watson is running a series of seminars on the potential implications of these principles for clients. For further information please see our events registration page on towerswatson.com

Pensions Regulator consults on multi-employer schemes guidance

On 1 July 2010, the Regulator launched a consultation on guidance, aimed primarily at trustees of multi-employer schemes focused largely on employer debt. Having looked at the whole process, the Regulator urges trustees to take an holistic view as to the effect of changes to the structure of multi-employer schemes and group sponsors and cross-refers to the recent draft *Guidance on monitoring employer support*.

The document gives no guidance as to the Regulator’s view of the problems associated with employment cessation events (ECEs). Instead, it indicates that the Regulator expects trustees to:

- Understand the employer covenant – before, during and after an ECE (possibly long after in the case of a guarantor).
- Identify all liabilities and the employer responsible for them.
- Understand the range of options, assess their impact and consider ways to mitigate the associated risks.
- Understand the processes involved with each option.
- Recognise and manage any conflicts.

A number of other points merit further mention. For instance, because employment cessation may result in an irreversible reduction in the strength of the overall covenant, the Regulator considers that trustees should seek mitigation through measures such as guarantees or contingent assets. It should do this where the departing employer’s covenant is strong relative to the remaining employers and it meets its full liability share.

In other cases, it suggests trustees should also be cautious about consenting “far in advance” of an ECE to alternatives to a departing employer paying its full liability share.

In considering the guarantee provided under a withdrawal arrangement, trustees should have regard to other guarantees made by any guarantor and should routinely monitor it “as they would any sponsoring employer”. Moreover, trustees should be cautious about permitting payment of a reduced debt on withdrawal in instalments.

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The guidance also emphasises the complexity of the legislation and the need for the trustees to take professional advice. The consultation ends on 23 September 2010.

Next steps on auto-enrolment and increasing State Pension Age

The Department for Work and Pensions (DWP) has announced two reviews of legislation: one in respect of how and when to increase the State Pension Age (SPA) to 66 and the other reviewing how to implement automatic enrolment effectively.

Increasing the SPA

The DWP has issued a call for evidence to inform its decision on when to increase the SPA to 66 and this will consider:

- The evidence concerning changes in life expectancy and the changed economic context when bringing forward increases to the SPA.
- How much notice it should give individuals who would be affected by the change.
- The relevant evidence to ensure no group is disproportionately impacted by the increase in the SPA to 66.

The Government has said it will not start increasing the SPA to age 66 before 2016 for men and 2020 for women. Although this review is focused on this initial increase, the Government is also considering whether and how to accelerate subsequent rises in the SPA, which is currently scheduled to reach 68 by 2046.

It invites submissions of evidence by 6 August 2010 and will publish its response in the autumn.

Review of automatic enrolment

“Three independent experts” will look at how to make automatic enrolment work and will report back to the Government by the end of September. The scope of the review is to examine whether the current measures strike an appropriate balance between the costs and benefits to both individuals and employers, or whether an increase in saving could be achieved by changing how the rules are applied.

The review will consider:

- The earnings threshold above which employees will be enrolled.
- Whether auto-enrolment should apply only where contributions reach a ‘de minimis’ limit.
- The age restrictions.
- The size of firm to which automatic enrolment should apply.
- Whether employees should be automatically enrolled on their first day of work.
- The availability and capacity of pension providers other than the National Employment Savings Trust to serve the potential automatically enrolled population.

Among the review’s objectives in considering these issues are reducing pensioner poverty, maximising voluntary private savings, minimising burdens on employers and maximising value for money for the Exchequer. The review will assess whether alternative approaches could obtain better value for money and will inform wider discussions on affordability and value for money in the context of the next Spending Review. Responses to this review are requested by 13 August 2010.

Green Paper opens up debate on solvency measures

The European Commission’s Green Paper seeks views on how to improve the adequacy and sustainability of both State and private pensions throughout the European Union.

The Paper’s statements have predominantly drawn comment on how to deal with the demographic challenge of improving longevity. The favoured approach appears to be to increase pensionable age and to ensure that measures are in place to support longer working lives.

Of greatest interest to sponsors of schemes with defined benefit rights is the proposal to design a new solvency regime specifically for pensions. Although the Commission has previously consulted on this topic, until now the scope of its proposals was restricted to the few schemes that either carry on cross-border activity, or, without recourse to the sponsor provide investment guarantees or cover biometric risks. The latest Green Paper proposes no such restriction.

Moreover, it seems that the Commission is resolute that the starting point will be Solvency II – the regime that will apply to insurers after 2012. The Paper states that this will be subject to “adjustments to take account of the nature and duration of the pension promise”, but provides no more detail.

Given the Commission’s ongoing enthusiasm for using Solvency II as the foundation for any future funding standard, the importance of the rigorous impact assessment promised cannot be overstated. The Commission states that this will examine, in particular, “the influence on price and availability of pension products”. It is, perhaps, unfortunate that the Commission insists on thinking of pension schemes as ‘products’, which implies a commercial quality rather than the less tangible notion of a dynamic agreement that is the outcome of negotiations over time between the interested parties.

Most of the other proposals in the Green Paper should be relatively benign in the context of existing UK legislation. For example, resurrecting the Portability Directive that concerns the acquisition, revaluation and portability of pension rights to support greater worker mobility and making improvements to the disclosure of information to members to facilitate informed decision-making. Outside of this relative comfort the Paper does raise the notion of establishing an EU-wide ‘pension benefit guarantee system’. It is suggested that this might even seek to compensate for excessive losses in DC pensions – though quite what this means is unclear.

Finally, the Commission believes that improvements to the Pensions Directive are necessary as this has not created the hoped-for internal market for cross-border provision. In particular, the Paper suggests that the Commission wants to extend the Directive’s coverage to include unfunded and funded mandatory arrangements and for it to be more ‘flexible’ in adapting to change. It is no surprise to those who follow cross-border developments that the Paper also states that the Directive is inconsistently interpreted by Member States – particularly in the context of what constitutes cross-border activity – and does not deal adequately with differing social and labour law. If changes are made as the Commission appears to wish, cross-border pension provision should become easier.

Pensions roundabout

Regulator tests true strength of its powers

The Pensions Regulator’s Determinations Panel has issued its first Contribution Notice – for £5 million in relation to the Bonas Group Pension Scheme, which entered into the Pension Protection Fund (PPF) assessment period in January 2007 and formally transferred into the PPF in November 2008.

On 14 May 2010 the Panel found that Michel Van De Wiele N.V. – the parent company of textile machinery

business Bonas – had retained the Bonas business while avoiding the pension liability, by placing Bonas into a pre-pack insolvency, and had not engaged openly with pension trustees or the Regulator. The parent company has appealed the decision.

The Regulator has also exercised its moral hazard powers in relation to the Nortel pension scheme. The Determinations Panel has decided to issue a Financial Support Direction (FSD) against 25 companies in the Nortel group in Canada, the US, Europe and Africa. The FSD on the target companies was issued after the employer of the Nortel Networks UK Pension Plan was found to be ‘insufficiently resourced’ having entered administration in January 2009.

The Panel found that the Canadian parent entities’ control over the UK Company’s financial position included whether, and to what extent, it contributed to the pension plan. It found that in the 12 years prior to 2002, the Nortel group benefited by paying little or no contributions to the scheme. The group also benefited from the controlling parent companies’ failure to adequately address the deficit from 2002 onwards.

June Mulroy, The Pensions Regulator’s executive director for delivery, said: “The FSD enables the scheme to have a voice in the insolvency proceedings of the target companies. The FSD is a UK regulatory process and is not an attempt to enforce outside of the Canadian or US insolvency processes. It provides certainty over the size of the pension debt for the courts and those supervising the Nortel insolvencies.”

BA secures £1.3 billion annuity transaction

One of the British Airways (BA) pension schemes has announced that it has secured £1.3 billion of liabilities through an insurance transaction with Rothesay Life (an insurance arm of Goldman Sachs). The insurance policy provides cover for some 20% of the pension payments due in respect of scheme members already in receipt of pension benefits.

The liabilities are covered by an insurance arrangement issued by Rothesay, under which the trustees retain ownership of the assets backing the transaction, providing significant protection for the scheme. In return for the proceeds from those assets, Rothesay Life pays the agreed portion of pensioner benefits to the trustees.

These synthetic buy-in transactions involve bringing together interest rate, inflation and longevity hedging to mimic a buy-in but with a security structure and flexibility that some pension schemes will find attractive. It can also be a way of taking advantage of investment opportunities not available through a conventional annuity.

We have seen a pick up in recent weeks in schemes looking at third-party risk transfer. Several other pension schemes we are advising have either recently completed or are nearing completion. We have already seen four £1 billion plus transactions.

Reform of institutional framework for financial regulation

In late July, Mark Hoban MP, the Financial Secretary to the Treasury, launched the Coalition Government’s consultation on plans to reform the institutional framework for financial regulation in the UK. Under the proposals, the Bank of England will take charge of macro-prudential regulation by having a Financial Policy Committee (FPC) established within it. The Governor of the Bank will chair this committee, which “will have the responsibility for considering the macroeconomic and financial issues that may threaten stability” and it will be given tools to address the risks it identifies.

Two new regulators will replace the Financial Services Authority (FSA). There will be a new Prudential Regulation Authority (PRA) under the Bank of England, headed on a day-to-day basis by a new Deputy Governor acting as Chief Executive and with the power to implement the FPC’s decisions on firms. The FPC will have the power to require the PRA to implement its decisions through regulatory action.

There will also be a Consumer Protection and Markets Authority (CPMA) which will take on the FSA’s responsibility for consumer protection and conduct regulation. It will regulate the conduct of all firms, both retail and wholesale – including those regulated prudentially by the PRA – and will take a proactive role as a strong consumer champion. The consultation closes on 18 October 2010.

FRC confirms 2010-11 levies

The Financial Reporting Council (FRC) has confirmed that the levy rates it applies to pension schemes with more than 1,000 members will increase by 15p per 100 members to £3.15.

The FRC obtains the levy from three sources, with 10% paid by the actuarial profession and the remaining 90% split evenly between pension schemes and insurance companies. The levy is based on the latest information on the total membership for each scheme provided to the Pensions Regulator in scheme returns. The levy applies to occupational and personal pension schemes and public service pension schemes. Only those schemes with at least 1,000 members (effectively covering 85% of the total membership of pension schemes) will be required to pay the levy.

Pension funds allocate across the breadth of alternative assets

Towers Watson's *Global Alternatives Survey* found that alternative assets under management on behalf of pension funds by the world's largest alternative investment managers remained unchanged in 2009 compared to the year before at US\$817 billion.

The research, produced in conjunction with the *Financial Times* also shows that around half of all assets managed by these alternative investment managers are managed on behalf of pension funds.

The survey covers five alternative asset classes: real estate; private equity fund of funds; fund of hedge funds; infrastructure and commodities and includes rankings of the top managers in each area.

Visit towerswatson.com to read the survey.

Seminars on Enhanced Transfer Value (ETV) exercises

The implications of the principles set out by the Regulator (see article on page 2) are potentially far-reaching for any sponsoring employer considering an ETV or PIE exercise, and for the scheme's trustees. We have therefore set up a series of client seminars to explain the principles and their implications. Contact your usual Towers Watson consultant if you are interested in attending a seminar.

Further information

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

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