

# In Sight

Quarterly Pension Publication

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## Welcome to In Sight

In this issue we consider consultation documents from the DWP and the Pensions Regulator, as well as the implications of recent court cases, before tidying up a collection of amendments that took effect from 6 April 2009.

### This quarter's round-up

- **Investment insight**  
Quantitative easing, the latest policy offensive to combat recession is raising the risk of extreme inflation scenarios, argues this article from the Hewitt Asset Allocation Team.
- **Scheme funding in these exceptional times**  
The Pensions Regulator reassures employers that the funding regime for defined benefit schemes is flexible enough to cope.
- **Budgetary constraints**  
Announcements in the Budget restrict pension tax relief for high income earners with immediate effect.
- **Highly principled**  
The DWP consults on the principle and practice of keeping members informed about their pensions.
- **Practically impractical**  
Draft regulations for automatic enrolment in pension schemes add to the administrative burden with tight, potentially unworkable, timescales.

- **Spring cleaning**  
A collection of amendments to pensions law that take effect from 6 April 2009.
- **Inflexible retirement**  
Uncertainty continues as recent developments around age discrimination deter employers from fully embracing phased retirement options.
- **Trivial things take time too**  
We report on delays to the new regulations around commuting trivial benefits for cash.
- **The High Court and the Ombudsman – priorities differ**  
We look at the differing interpretations of an 'underpin' and how this may affect priorities on wind up.

### Regular features

- **On the horizon**  
Forthcoming developments.
- **Governance diary**  
The Pensions Regulator releases final guidance on record keeping.
- **Seminar dates**  
Trustee training seminars and teleconferences for 2009.

## Investment insight

### Quantitative easing poses new risks

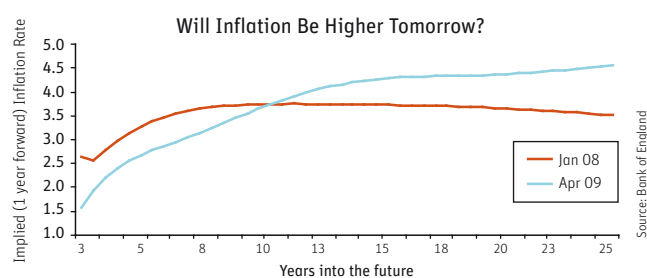
That we are in a deep and drawn-out recession is widely understood. What may not be quite as apparent are the implications of the latest policy offensive to combat this – quantitative easing, a policy that seeks to raise the quantity of money circulating in the economy. Hewitt’s asset allocation team believes that this is raising the risk that we could enter an undesirable inflationary world (inflation goes above 5%) or indeed a deflationary one, where prices fall, not just temporarily but for a number of years.

Increasing the quantity of money deliberately takes the risk that too much money is created, and that it cannot be easily withdrawn as the economy recovers. Much higher inflation could be the eventual result, jeopardising the Bank of England’s 2% inflation target. However, exactly the opposite risk is also very much lurking in the background. Since quantitative easing uses the last reserve of policy makers’ ammunition to combat recession, a failure to revive economic activity carries the risk that business and consumer confidence is seriously damaged. This could entrench deflation, leading to falling wages and prices.

### More evidence of inflation uncertainty

There is more evidence of inflation uncertainty around us. Break-even inflation rates in bond markets (the difference between conventional gilts and index-linked gilts of equivalent duration), a key indicator of the market’s long-run inflation expectations, are behaving more erratically. Since last summer, the break-even inflation rate on 10 year gilts has moved between 0.8% and 4.1%, and that on 20 year gilts has moved between 2.3% and 4.2%. These wide ranges are a tell-tale sign of rapid fluctuation in views on long-term inflation, as well as more dispersion in these views. The Bank of England calculates the path for expected inflation from bond market

data, and this has been looking steep recently, suggesting that the market could be worrying about higher inflation over the longer-term.



### Pension scheme impact

For investors, inflation uncertainty, especially around extreme outcomes, presents major problems. Asset allocation in an inflationary world should be very different to a deflationary one. Deflation benefits fixed income instruments – such as fixed income gilts. Other asset classes are unlikely to do well in a period of deflation, though selected hedge fund strategies should still deliver reasonable absolute returns. An inflationary world requires a wholly different orientation, the appropriate focus being on index linked gilts and other long-term inflation hedges such as property, commodities and infrastructure investments.

All this is difficult enough, but as schemes have liabilities, additional questions are raised. It is difficult to generalise about the liability impact since the precise effect will depend on some scheme-specific considerations. However, both the inflation and deflation extremes will pose obvious challenges. For example, pensions cannot be readily cut even when prices are falling, and low bond yields could raise the value of liabilities. The key difficulty is gauging whether the liability impact offsets the asset impact or reinforces it.

## Hewitt’s view

Hewitt’s asset allocation team is working with an assumption that moderate inflation continues, but we do believe that the time has now come for schemes to consider what might happen if these extreme inflation scenarios arrived and what should be done about it.

The risks of undesirable deflation or high inflation aside, there is a potentially brighter side to quantitative easing. The central aim of this policy should not be forgotten – it is to prevent the economy falling into a deeper slump. If it works in bringing an economic recovery forward, everyone benefits. Equities still remain an important part of most schemes’ assets, and would benefit from an earlier end to the recession. This would provide a strong boost to the financial health of most pension schemes.

# “There is no reason why a pension scheme deficit should push an otherwise viable employer into insolvency.”

The Pensions Regulator’s Statement to Employer Sponsors of DB Pension Schemes, February 2009

## Scheme funding in these exceptional times

### Flexibility to cope with the economic downturn

In February 2009, the Pensions Regulator issued a statement to employers who sponsor defined benefit schemes. This follows a similar statement issued to trustees in October 2008.

The Regulator wanted to reassure employers that the funding regime set out in current law is flexible enough to cope with the economic downturn. The flexibility allows for recovery plans to be re-opened and extended, possibly beyond the Regulator’s 10 year trigger, if it might otherwise jeopardise the employer’s financial position. It also recognises that short-term concerns over affordability might mean that is

appropriate for recovery plans to be “back-end loaded”, to ease pressure on cashflows.

### Re-negotiation – a word of warning

The Regulator believes that recovery plans should not suffer so that companies can continue to pay dividends to shareholders. The Regulator does not necessarily suggest that employers who are renegotiating recovery plans should stop paying dividends, but it expects trustees to consider their position as “unsecured creditors”, with priority over shareholders, in any renegotiation.

## Budgetary constraints

The Government announced in the Budget that it intends to restrict tax relief on pension contributions for high earners from 6 April 2011. The relief will be tapered away for those with incomes above £150,000, so that for those with income over £180,000 it is worth 20%, the same as a basic rate taxpayer.

An **immediate** reduction in tax relief on additional pension contributions by high earners has also been announced, to prevent the bringing forward of pension savings ahead of the 2011 measures.

Tax relief is to be limited to 20% on additional pension savings by high earners on or after 22 April 2009. It will apply where:

- An individual has earned more than £150,000 within the current or one of the previous two tax years; and
- Total pension savings in the year exceed £20,000; and
- Pension contributions have been increased since 21st April 2009.

It will see the introduction of a special annual allowance of £20,000:

- An increase in pension contributions or material change to defined benefit accrual will be tested against the allowance; and
- A special annual allowance charge of 20% will be levied on the new or additional savings over and above the allowance.

Effectively, tax relief is granted at the high earner’s marginal tax rate and then this relief is reversed by applying a 20% charge. (This charge may be increased to 30% when the new 50% tax rate is introduced in April 2010.) The special annual allowance charge will be collected from the individual via their Self Assessment tax return.

For the special annual allowance charge, contributions and benefit accrual will generally be measured as for the existing annual allowance. Employer and member contributions will be considered for money purchase schemes, and the increase in the value of the individual’s rights for defined benefit schemes.

To count as normal regular savings, and not trigger the special annual allowance test, money purchase contributions will have to have been made on a quarterly or more frequent basis prior to 22 April 2009. This would preclude one-off contributions made from, say, annual bonuses.

Some new or material changes to pension saving will not trigger the test, including:

- A change is made to a defined benefit scheme which applies to at least 50 active members of the scheme, and the member was a member of the scheme on 22nd April 2009;
- New pension saving where at least 20 other members accrue benefits on the same basis.

Scheme administrators will be permitted (but not required) to refund contributions where the high earner makes contributions without realising that they would not be subject to full tax relief.

# “Members should be given sufficient information that allows them to understand the benefits to which they will be entitled and any other relevant information that will enable each member to make decisions in his or her own best interests”

Single, high level principle on disclosure proposed in DWP Consultation on Review of Disclosure of Information Requirements, March 2009

## Highly principled

In March 2009 the DWP issued a public consultation document on restructuring and simplifying the existing regulations for the disclosure of information to members. The consultation follows Lewin’s and Sweeney’s 2007 “Deregulatory Review of Private Pensions”, which recommended exploring a “principles-based” approach to regulation, using the disclosure requirements as a pilot.

The DWP’s current consultation states that an entirely principles-based approach is not appropriate for disclosure requirements, as it would lack necessary clarity in interpreting the requirements. It would also be in breach of an EU Directive that requires specific disclosures. However, it proposes the following approach:

- Introducing a single high-level principle (see box) for schemes to follow when they interpret the regulations and make their arrangements to disclose information.
- Restructuring and simplifying the current disclosure regulations, replacing them with a single set of

regulations to apply to occupational, personal and stakeholder pension schemes.

- Introducing some deregulation in the following areas:
  - Basic information about the scheme;
  - Annual report;
  - Annual information; and
  - Statutory money purchase illustrations.
- Requiring “reasonable periods” for providing information, rather than specifying timescales. A Code of Practice would include guidance on timescales.
- Allowing schemes to provide information to members electronically. Many schemes may welcome this change.

The DWP expects to publish draft regulations by the end of this year with new legislation in place from 6 April 2010, in time to apply to the new auto-enrolment requirements from 2012 discussed below.

## Practically impractical

From 2012, employers must automatically enrol eligible workers into a qualifying pension scheme of the employer’s choice. The Government has now published draft regulations on the process of exchanging information for auto-enrolment. These include tight timescales for employers and significant administrative burdens even if workers subsequently opt out. The Government claims it has attempted to strike a balance between:

- Allowing enough time for people who will want to opt out and for administrative tasks such as aligning payroll records; and
- Not making scheme administration too complex, particularly around contribution refunds.

For occupational pension schemes, the joining process is that:

- The employer must provide “enrolment information” to the individual within 14 days. This period is called the scheme joining window.
- Scheme membership starts on the day the employee starts work.
- The employer must provide the scheme with specified information about the employee – for example, name and date of birth – so that the scheme can set up the employee as a member.

- The member must receive information about the scheme.

The steps in the joining process for an employee to be enrolled into a personal pension scheme are slightly different. The 14 day scheme joining window applies, but in two stages:

- Within 7 days of starting work:
  - The employer must provide the employee with enrolment information; and
  - The employee must receive a key features statement about the scheme (a KFS).

The employer can take up to 7 days from the start of the employment to provide the specified information about the employee to the scheme. (If the scheme is to send the KFS within 7 days, providing the scheme with the information will need to be accelerated. The alternative is for the employer to keep stocks of the KFS to give to the employee.)

- This 7 day initial period is followed by a further 7 day period for the employee to consider the contract terms before he is deemed to be a party to the contract.

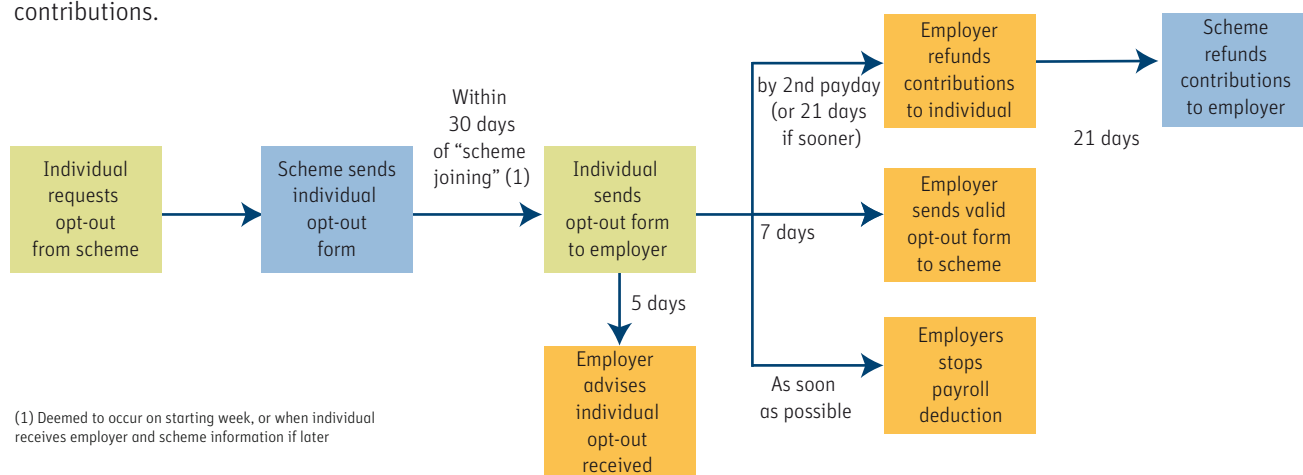
In all circumstances, the employer must start to make payroll deductions and pay employer contributions from the first payroll after the employee starts work – another tight timeframe.



Employees will have the right to opt out of membership of a pension scheme. However, the opting out process can only start after the scheme joining window has closed. As the joining window can last as long as 14 days, a lot of administration will have already been carried out and, in many cases, contributions will have been debited, before the “reversal” process can even begin.

The responsibilities for opting-out are split distinctly between scheme, employer and member:

- The employer is not allowed to provide the prescribed opt out form in case by doing so he is encouraging the employee to opt out.
- After supplying the form, there is no further communication between the scheme and the employee – the employer does all the communicating and refunds the contributions.



The responsibilities and time frames are summarised in the flowchart below.

Under the draft regulations, an employer can postpone automatic enrolment for up to 90 calendar days from when the employee starts work, provided the qualifying scheme is:

- A defined benefit scheme; or
- A defined contribution scheme with a minimum 11% total contribution, of which at least 6% is by the employer.

The Government has already indicated that this consultation is the first in the series of three consultations, with two further consultation papers on auto-enrolment and personal accounts planned for spring and autumn 2009. It is likely to provoke debate amongst employers.

## Spring cleaning

Several amendments were made to pensions legislation with effect from 6 April.

- A fixed ‘upper accrual point’ now caps the level of earnings that count towards the calculation of State Second Pension (S2P) and of rebates for schemes contracted out of S2P. The ‘upper earnings limit’ will continue to be used in the calculation of National Insurance contributions.
- For members leaving service, the statutory minimum revaluation for pensions is in line with the Retail Prices Index up to a maximum over the whole period from leaving to retirement. The previous maximum was 5% a year but schemes can now use a maximum of 2.5% a year for pension relating to service after 5 April 2009.

Trustees can now override scheme rules that prevent the adoption of this lower revaluation in deferment, or indeed of the lower rate of increase on pensions in payment allowed for post 6 April 2005 service. This means that

trustees can modify scheme benefits for future service to the new statutory minimum levels, where this would previously not have been possible.

- Employers who fail to consult with members on certain listed changes to benefits, originally introduced in the Pensions Act 2004, will now be subject to fines of up to £50,000.
- The list of events which trustees and employers may need to notify to the Pensions Regulator is reduced, to exclude changes in key posts and changes to the employer’s credit rating.
- Members with pension credits granted under a pension sharing order on divorce now have the flexibility to take these benefits early and partially in lump sum form, in the same way as other scheme members, rather than being restricted to pension from no earlier than 60.

# “The Age Regulations continue to cause some increase and uncertainty for employers, trustees, professional advisers, members and their representatives alike ”

Government Response to the Consultation on Flexible Retirement and Pension Provision, December 2008

## Inflexible retirement

Two recent developments around age discrimination may affect employers and pension schemes but as neither issue has been resolved definitively, uncertainty is likely to continue.

### Heyday

The European Court of Justice (EJC) has given its judgement in the Heyday case. Heyday (an organisation developed by Age Concern) claimed that UK laws allowing employers to force employees to retire at age 65 breached the EU's equal treatment directive.

As expected (after the Spanish Courts had referred a similar case to the ECJ), the ECJ did not agree with Heyday. It maintains that legislation which enables compulsory retirement at 65 is allowed, providing it is “justified by legitimate social policy objectives, such as those related to employment policy, the labour market or vocational training”.

The case has now been referred back to the UK High Court to determine, amongst other things, whether UK legislation is justified by those objectives. In particular, the ruling suggests that legitimate social policy objectives should be different from the interests of employers, such as cost reduction or improving competitiveness. Some experts have suggested that the Government will find it difficult to prove that this is the case, and it is likely to be some time before a definitive decision is reached.

### Flexible retirement

One of the perceived advantages of the current pensions tax regime introduced in April 2006 was that it would enable flexible retirement. Members could continue working, possibly in a reduced capacity, and at the same time start drawing

some or all of their pension benefits. Although employers appeared interested in offering these options, the pension industry raised concerns that flexible retirement could conflict with age discrimination laws as they apply to pension schemes. Employers have therefore been waiting for these issues to be resolved before investigating flexible retirement in more detail.

The Government has published a response to its October 2007 consultation on these issues. It proposes adding to the already lengthy list of pension scheme practices that do not qualify as age discrimination, so that schemes need not provide a death in service benefit to members taking flexible retirement. They have also considered extending this so that schemes could stop members building up further pension benefits if they take flexible retirement.

However, these exemptions would only apply to a member who reduced their hours of work or their employment grade after at least age 65.

It seems unlikely that these latest proposals will significantly lessen the industry's concerns, as even the more wide-ranging exemption still only covers a number of specific situations. The proposals as drafted may even discourage flexible retirement arrangements, as employers may not want to offer a package unless it is covered by these narrow exemptions. The proposals are also likely to be of limited use because of the age restrictions – most requests for flexible retirement are likely to come from members wanting to wind down employment before their normal retirement age.

## Trivial things take time too

As previously reported, the March 2008 Budget included a number of proposed changes to the taxation of scheme benefits. In May 2008, the Government published draft regulations, which included the extension of the trivial commutation rules and changes in the treatment of some payments that are currently unauthorised.

The new regulations were expected to take effect later in 2008, but the Government put the regulations back from late 2008 to April 2009. They have now been delayed further. This will come as a disappointment to schemes wishing to utilise the new flexibility for trivial commutations or considering what action to take for payments that are unauthorised under the current rules. However, there was some good news for trustees. HMRC announced that it will not impose sanctions if schemes fail to report an unauthorised payment that would be authorised under the draft regulations.



## The High Court and the Ombudsman – priorities differ

A determination by the Pensions Ombudsman has conflicted with the ruling in a recent case brought before the High Court (Bridge Trustees v Yates). Both cases involved money purchase sections of schemes where members had been contracted out on a final salary basis and so included Guaranteed Minimum Pensions (GMPs).

The cases each dealt with the order of priority for providing benefits when a scheme is wound up. If benefits need to be cut back, the lowest priority classes are reduced first. Money purchase assets and liabilities are generally excluded from the priority order set out in pensions law and normally have priority over non-money purchase benefits. This means that money purchase benefits are usually met in full, whereas non-money purchase benefits may be cut back, and some parts may not be provided at all, depending on the assets available.

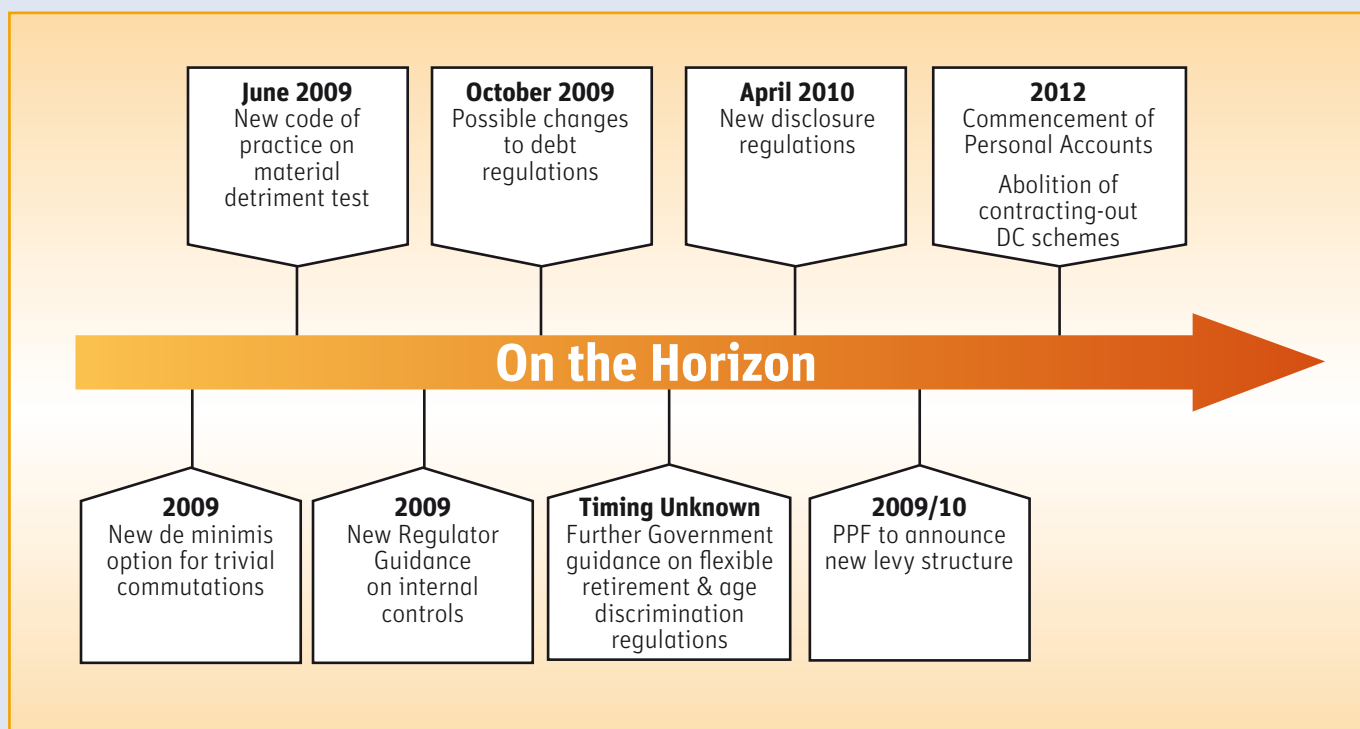
The High Court previously ruled that where a money purchase pot is used to provide a GMP, that pot falls within the definition of an ‘underpin benefit’ and hence is classed as a non-money purchase benefit within the priority order on wind-up.

However, in a subsequent case brought by Ms SG Williams, a member of the Applied Chemicals scheme, the Ombudsman ruled against the trustees who had taken this view. He decided that a money purchase pot used to provide a GMP was not an ‘underpin benefit’. It should be treated as a pure money purchase benefit falling outside the scheme’s priority order and not be reduced.

Surprisingly, the Ombudsman did not refer to the High Court case. However, despite this apparent oversight, it seems unlikely that the trustees will appeal Ms Williams’ case as the amount involved is relatively small.

## On the horizon

Key dates for expected legislative developments impacting occupational pension schemes are highlighted in the chart below.



## Governance diary

The Pensions Regulator released final guidance on record-keeping in January to help improve standards of administration and record-keeping across the industry. Although the Regulator's approach is to educate and enable, it has not ruled out enforcing the standards at a later stage.

The guidance suggests an approach to test whether the member records hold the complete information needed to calculate a member's benefits (rather than testing accuracy). The guidance suggests a framework for testing the data, divided into three categories of tests:

- **Common data** – basic member details required by all schemes such as name, date of birth.
- **Conditional data** – details that depend on the benefit design of the scheme such as salary history, national insurance history, member contributions history.
- **Numerical data** – summary statistics designed to test the reasonableness of the records using numbers of members with specific criteria, such as a part-time history, transferred-in benefits or pension sharing orders.

Administrators can develop templates for reporting to trustees, or use the template provided.

The Regulator suggests the most common events which should be used as a trigger for data testing are:

- Benefit statements;
- Valuations;
- Cessation of contracting-out;
- Closure to future accrual;
- Mergers or acquisitions; and
- Change of investment manager.

The guidance also notes that there are certain times when a data audit should be undertaken because benefits must be accurately calculated for all members at that point. These include a change of administrator, buy-out, wind-up and PPF entry.

## Seminar Dates

Full Day Course	2009 Dates
Introduction to Trustees' Responsibilities	18 May (Birmingham), 4 June, 15 July
Essentials for DB Trustees	24 June
Essentials for DC Trustees	13 May, 7 Sept (Birmingham), 16 Sept
Investment Essentials for DB Trustees (half day)	25 June
PMI Award in Pension Trusteeship (2 days)	21/22 Oct This course is held in Woking

Where we have not given the location in the table, the courses are held in central London.

## Teleconferences

Keep up with current issues from the comfort of your own desk through our regular series of one hour teleconferences. Aimed at trustees, these will help you to keep abreast of current pension matters and developments in the industry and discuss the practical issues you should be considering.

The teleconferences are free of charge – to register to attend, email: [ukevents@hewitt.com](mailto:ukevents@hewitt.com).

### 2009 Teleconferences 14 May, 10 Sept, 26 Nov

The May teleconference will consider the impact of recession on employer covenant – whether it is being affected and what trustees might need to be doing to monitor it.

### If you have any questions, please speak to your usual Hewitt consultant or contact Maggie Cruise on:

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