

In Sight

Quarterly Pension Publication
November 2009/Issue 8

Welcome to In Sight

Information about the latest developments in pension scheme regulation is vital for anyone involved with running a work-based pension scheme. This issue of In Sight considers alternative solutions for financing defined benefit schemes and looks at the work-in-progress on introducing Personal Accounts.

This quarter's round-up

- **Not the only answer ...**
With more and more schemes facing growing deficits, we explore the alternatives to higher cash contributions.
- **A work in progress**
The DWP is consulting on the timetable and requirements for automatic enrolment.
- **Leaving debt behind?**
In future, a debt to the pension scheme may not always follow a company's restructuring.
- **Pension Protection Fund news**
Winners and losers as the PPF aims to stabilise the total levy it collects.
- **Heyday: lawful ... for now**
A default retirement age of 65 is lawful, pending the government's 2010 review.
- **The Special Annual Allowance**
HMRC updates its Manual for the SAA.

Regular features

- **On the horizon**
A glimpse of expected future developments.
- **Governance Diary**
We look at areas of changed guidance we can expect in the next few months.
- **Seminar dates**
Trustee training seminars and teleconferences for 2009/10.



Not the only answer ...

In a recent survey by Hewitt, nearly 90% of respondents were expecting higher scheme funding deficits at their next valuation. Over half of these predict that the increased deficit will lead to higher contributions than the employer can reasonably afford.

Alternative finance solutions help manage cashflows or give additional security to the pension scheme without the use of cash. Company assets or another form of security or guarantee are conditionally granted to the pension scheme to cover a specific event (the contingency). Examples of contingent events include the employer becoming insolvent or the scheme's failure to reach a pre-agreed funding target.

Why use alternative financing?

Alternative financing can be used on its own to replace cash contributions to a pension scheme or it can be used to support other actions which reduce deficit contributions.

For example:

- To support a longer recovery plan, or back-end loaded plans;
- To increase security when a recovery plan relies on allowing for additional asset outperformance;
- To allow trustees and the employer to set lower technical provisions;
- To reduce the scheme's PPF risk-based levy.

The Pensions Regulator accepts the use of certain contingent assets in its regulation of scheme funding and the PPF recognises some types of contingent assets in its levy calculations.

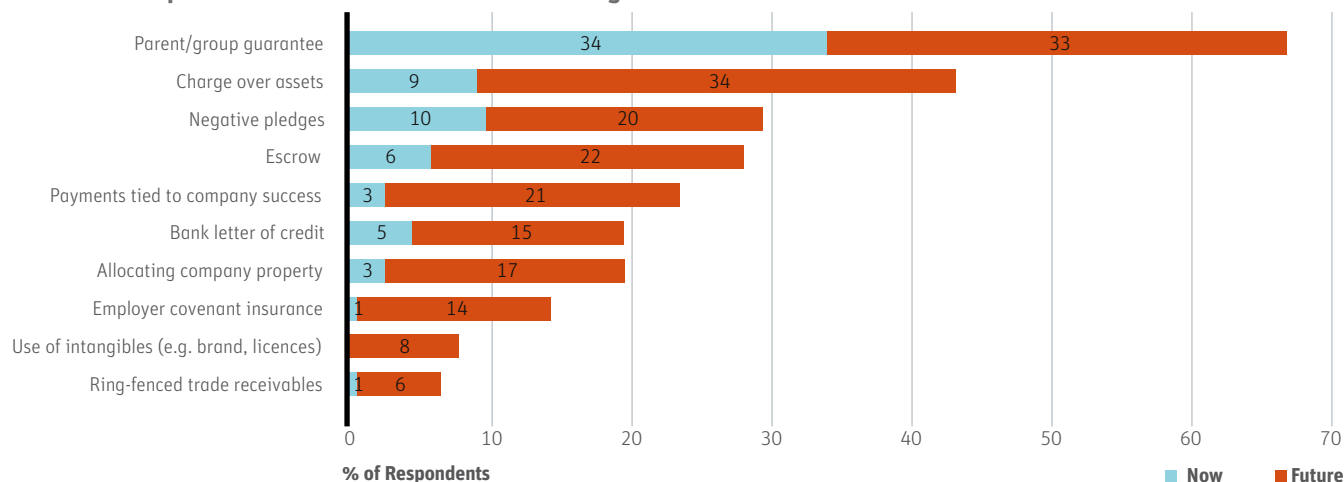
A recent Hewitt survey of over 150 employers and trustees examined how they were dealing with scheme deficits in today's tough economic conditions. The chart below shows the reasons respondents gave for using alternative finance for scheme funding both now and in the future.

Types of contingent assets

Typically, contingent assets take the following form:

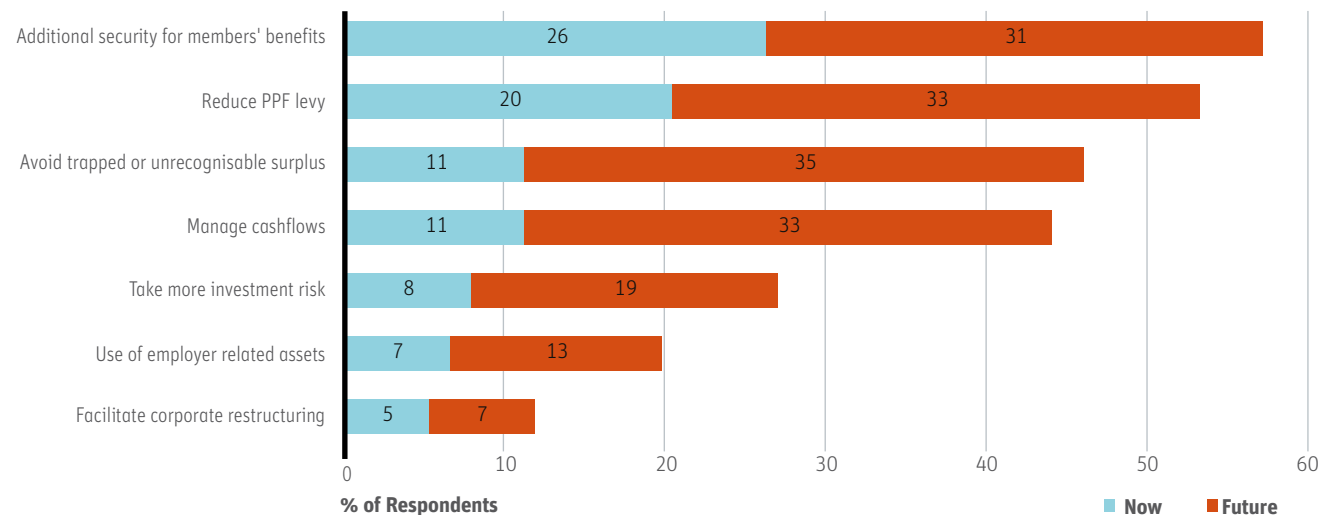
- **Parental guarantee** The parent company of a corporate group guarantees some or all of the pension debt of its subsidiaries.
- **Security or charge over an asset** The company grants the trustees a fixed or floating charge over named company assets, for example a building owned by the company.
- **Enhanced creditor status or subordination** The other creditors of the sponsoring employer agree that debts owed to the pension scheme will have priority over other claims if the employer becomes insolvent.
- **Escrow account** Under this legal arrangement an asset is placed in safekeeping under the trust of a neutral third party, such as money deposited in a bank account. At the end of an agreed period, or when a specific event occurs, for example the employer's insolvency, the escrow agent will deliver the escrow assets to the trustees of the pension scheme.
- **Bank letter of credit** The letter of credit allows the trustees to draw money from a third party bank in certain situations. As well as agreeing the circumstances under which money can be drawn, the maximum amount available is also specified. An alternative to letters of credit would be sponsor covenant insurance, but the market for this type of cover is still in its infancy.

Current and expected future use of alternative financing



“The best outcome for scheme and employer is a viable sponsor that will continue to support the scheme”.

Reasons for the use of alternative financing



Increasing use

Over half of the respondents to our survey were already using some form of alternative financing. Over 80% of those surveyed expected to use alternative financing for their pension scheme in the future.

A favoured solution

Parent company guarantees are by far the most common of the alternative finance solutions used by respondents to the Hewitt survey. It is one of the simplest and lowest-cost solutions to implement. It has also been the favoured solution for reducing the PPF levy – a key driver for the use of alternative financing to date.

While trustees will always prefer cash, they and others (including the Pensions Regulator) recognise that some employers are finding it difficult to meet pension funding requirements through cash alone in the current economic environment. Agreeing to put in place some form of additional security with the trustees can be a way to support the scheme without bankrupting the employer.

Points to consider

There are many considerations when planning to use alternative financing. We list some of these here:

- Providing a guarantee could limit the parent company's ability to borrow in the future, or increase the immediate cost of raising additional finance for the company;

- Although granting the pension scheme a charge over company property or business assets might be attractive to an asset-rich company, the pension scheme could find it difficult to assign a value to the assets. How easily the asset can be converted into cash for the scheme also needs to be considered.
- Is an insurance company likely to accept the contingent asset in part or full payment of the insurance premium if the scheme winds up?
- Will an escrow account increase a scheme's PPF levy by affecting the employer's Dun and Bradstreet failure score?
- Will the trustees need to renegotiate with the employer when the bank letters of credit come up for renewal? Renewing letters of credit can be problematic currently, and a tightly-worded funding agreement might require a renegotiation.

Your scheme is unique

When you investigate whether alternative finance will provide a useful solution for your scheme, you need to base your decision on a careful consideration of the particular circumstances of the scheme and its sponsoring employer. Scheme-specific aspects that affect the decision include:

- the unique pattern of the company's financial and asset base;
- the long-term strategy for reducing risks to the scheme; and
- any plans for re-structuring the company in the near future.

A work in progress

On 24 September, the DWP launched extensive consultations on various aspects of Personal Accounts and the workplace pension arrangements that will qualify as suitable alternatives.

Phasing in

Employers who provide a qualifying workplace pension arrangement for their employees must set up automatic enrolment processes for 'jobholders', employees who receive earnings above £5,035 a year (in 06/07 terms).

This requirement will be phased in over a three year period, from October 2012 to September 2015, based on the employer's size (measured using PAYE data). Larger and medium-sized employers must implement the new requirements over the first year, with smaller employers implementing auto-enrolment over the following eighteen months to two years. Employers will be able to opt for an earlier date.

Some employers providing membership of a defined benefit or hybrid scheme will be able to defer auto-enrolment until October 2015. They can do this as long as jobholders can join the scheme on a voluntary basis. However, if the scheme is closed before October 2015, the original staging date will apply and contributions must be backdated to the original automatic enrolment date.

The minimum required contributions where employers provide DC schemes will be phased in over five years:

Starting from	Minimum contributions	
	Employer	Total
October 2012	1%	2%
October 2015	2%	5%
October 2016	3%	8%

Enrolment issues

For employers using their own DB scheme or DC scheme with at least 11% total contributions (of which 6% is employer), the DWP proposes an optional waiting period of up to three months before new jobholders must be placed in the scheme. However, employers cannot operate a waiting period for jobholders on short-term contracts of three months or less.

Every three years on the anniversary of the employer's staging date, the employer must automatically re-enrol all eligible employees. The only exception is if a jobholder has opted out of the scheme within the previous 12 months. Re-enrolment should automatically take place if an individual regains jobholder status after losing it, for example because of a temporary dip in earnings.

Some individuals may fall outside the automatic enrolment age bands because they are aged between 16 and 22 and over State pension age but under 75. Within one month of these employees becoming eligible to opt in, the employer must tell them how they can opt in. The opt-in process will be similar to automatic-enrolment. They will be eligible for the employer contribution.

Individuals earning less than £5,035 a year will also be entitled to join a pension scheme. This does not have to be the same scheme that the employer provides for jobholders and these individuals do not have the right to an employer contribution. The employer must tell them their options within one month of them starting work.

The DWP's original proposals would have required member and employer contributions to have been paid to the scheme by the 19th day of the month following the month they commenced work. The latest consultation proposes to extend that by one month to more easily facilitate refunds by the employer for those who choose to opt out.

Qualifying through quality

Employers can only enrol jobholders into their own scheme automatically if it meets a quality test. In straightforward cases, an employer can self-certify a scheme. Others will need an actuary's certificate. The Pensions Act 2008 outlined the quality test but the consultation proposes further details, including:

- For DC schemes, employers can generally continue to calculate contributions on basic pay but a certification process will need to be completed, confirming that certain conditions will be met regarding the contribution rates.
- For DB schemes, stand-alone lump sum benefits at retirement may be taken into account, but discretionary benefits generally cannot.
- For career average (CARE) schemes, revaluation must match the requirements for final salary schemes, although the Government is consulting on how to treat schemes with discretionary revaluation.
- For hybrid schemes that provide both DB and DC benefits, there are detailed proposals for how the quality test should operate in various scenarios.
- Non-UK schemes can qualify provided they meet some additional tests.

The DWP has also published draft guidance on default options for DC schemes. If DC schemes are to qualify as an alternative to Personal Accounts they must provide a default investment option, so that members who are automatically enrolled do not have to make a choice.

“Our aim has been to allow as many existing schemes as possible to meet the required standard, thereby making it easy for employers who already have good schemes in place to meet the requirements”.

DWP, 24 September 2009

Policing employer's schemes

The Pensions Regulator (TPR) will “educate, enable and enforce”. Employers will be required to provide information about how they have met their automatic enrolment duties, registering within nine weeks of their staging date. Re-registration will also be required every three years, within nine weeks of the re-enrolment date.

Employers and schemes will need to keep records relating to their pension arrangements, including details of the opt-out and opt-in arrangements and contributions made, for a period of six years. TPR may require these records to be produced on request.

If employer contributions are unpaid, TPR can require employers to pay them and has the power to add interest for late payment at its discretion.

TPR also has wider powers to issue fines in the event of non-compliance, of up to £10,000 a day for larger employers.

Leaving debt behind?

Employers taking part in multi-employer schemes have been concerned that leaving the scheme because of corporate restructuring could trigger significant employer debt payments. In September, the DWP issued a consultation document, which sets out its proposals for greater flexibility around Section 75 debts. Under the latest proposals, some restructuring could take place without triggering a Section 75 debt, if certain conditions are met.

These are the main conditions proposed:

- No more than two employers should be involved and the transfers of all employees, pension obligations and assets from one employer to the other must take place on the same date.
- The trustees must be satisfied at the time of the transfer that:
 - the receiving employer will be at least as likely as the exiting employer to meet the transferred liabilities; and
 - the receiving employer will be at least as likely to meet its own liabilities as it was before the transfer.
- Both employers must notify the trustees that an insolvency event is unlikely to occur in the next 12 months.

Also, a simplified approach would apply for very small-scale reorganisations where the defined benefit liabilities involved are less than £100,000 and the employer who is leaving the scheme employed fewer than 2% of the scheme's DB members.

A significant change

The DWP proposes revised requirements for sharing out pension liabilities when not all of a member's former employers can be identified. This part of the legislation is often used because of poor historic data. The proposals suggest attributing the liability to the member's most recent employer, where this is known. This would be a significant change from the current requirements where an alternative approach in this situation is allowed as long as it is “reasonable”.



Pension Protection Fund News

2010/11 levies

The PPF has published its consultation on the calculation of levies for 2010/11. This follows its announcement in June that the total levy it intends to collect would be kept stable, despite the current economic uncertainty. The total amount the PPF intends to collect in 2010/11 is therefore £720M, which is the 2009/10 figure of £700M increased in line with wages.

The method the PPF proposes for calculating individual schemes' levies is also largely unchanged from 2009/10. The proposed risk-based levy scaling factor is 1.64, compared to 2.22 in 2009/10. This decrease is mainly to offset the increase in schemes' deficits over the year to 31 March 2009, which would otherwise increase levies. The proposed scheme-based levy multiplier has also fallen because of an increase in the overall level of liabilities. The PPF proposes a multiplier of 0.0145% of a scheme's PPF liabilities, compared with 0.0162% for 2009/10.

What does this mean for individual schemes?

Stability in the total levy is unlikely to mean stability for individual schemes. Many schemes could see a significant increase in their 2010/11 levy, particularly those that are relatively better funded.

However, a small number of schemes will benefit from a significant reduction in levy, as the PPF proposes to reduce the cap on the risk-based levy from 1% to 0.5% of PPF liabilities. The PPF says that this change is designed to "protect the schemes struggling most in the recession, without having a significant effect on the levy scaling factor".

The PPF proposes to charge interest on late payment of 2010/11 levies.

Deadlines for certificates

Schemes can still take action to reduce their 2010/11 levy by certifying new contingent assets (or re-certifying existing ones) and by certifying deficit reduction contributions the scheme has received. Action must be taken before deadlines of 31 March 2010 and 7 April 2010 respectively.

Block transfers before 1 April 2010 of 100% of a scheme's liabilities need to be certified by 30 June 2010 in order to avoid a penal levy calculation. Significant partial transfers also need to be certified.

The consultation includes 'improved' standard form agreements for new contingent assets put in place after December 2009.

The PPF intends to publish its final determination before the end of 2009.

Future levies

In July, the PPF published its response to its November 2008 consultation on longer-term changes to the levy calculation. The PPF says it received broad support for the principles underlying its proposals, but recognised there were concerns about some 'key elements'. The PPF has formed two groups of industry representatives to develop the proposals further.

The PPF is aiming to publish a further consultation document on the new proposals in early 2010 and expects to publish its final policy later that year. Implementation would not be before 2012/13, a year later than originally planned.

Until then, levies are likely to follow similar principles to 2010/11. However the PPF will be publishing a further consultation on proposals for 2011/12 in November 2009. In particular, this will look at refinements to the methodology that Dun and Bradstreet use to assign insolvency probabilities to employers.



‘It will...be apparent from my observations...that the position might have been different if the government had not announced its timely review. I cannot presently see how 65 could remain as a DRA [default retirement age] after the review.’

High Court judgement of Mr Justice Blake, September 2009

Heyday: lawful ... for now

In March, the European Court of Justice (ECJ) referred the Heyday case back to the UK High Court. Heyday (an organisation developed by Age Concern) claimed that UK regulations failed to implement the EU’s equal treatment directive by allowing employers to retire employees at age 65.

The Government announced in July, after the ECJ judgment, that it would bring forward its review of the default retirement age to next year, in response to changing demographic and economic circumstances.

On 25 September, the High Court ruled that the Government’s decision to adopt a default retirement age of 65 was lawful. The judgment was based on the state of affairs in 2006, when the age discrimination regulations were made. The judge noted that if the regulations were being adopted in 2009 and the Government had not announced its 2010 review he would not have come to the same conclusion. The judge noted that he could not see how 65 would remain the default retirement age after this review.

The Special Annual Allowance

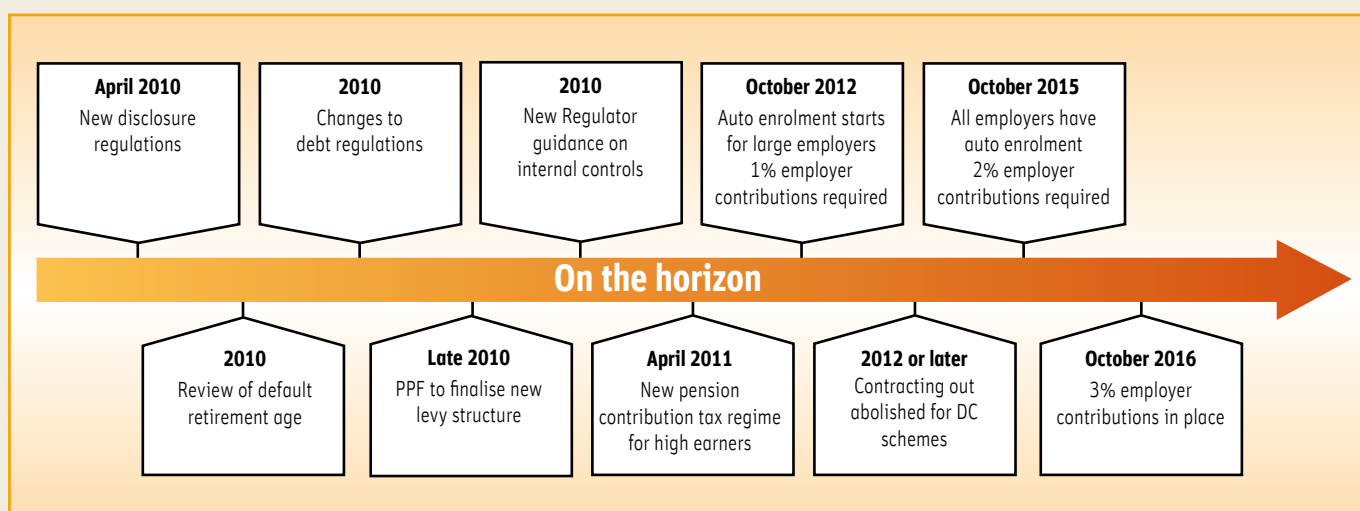
HMRC has issued new pages of its Registered Pension Schemes Manual on the Special Annual Allowance (SAA). Some points of clarification have been included.

The one which might be most commonly queried is what counts as an accruing member. The number of accruing members in a defined benefit arrangement is critical in several situations where exemptions from the Special Annual Allowance might apply. HMRC has clarified that members of schemes that are closed to future service are deemed to be accruing benefit if their benefits continue to be linked to future salary increases. Members with life assurance cover only also count as accruing benefits.

The new pages of the Manual seem to over-simplify some of the legislation. It may be sensible to double-check the source information before relying on the new pages or the included worked examples.

On the horizon

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



Governance diary

Trustee Knowledge and Understanding (TKU)

The Regulator's revised TKU framework is due to come into force in this month. One of the major changes will be that the original guidance on the scope of the framework will be split into three:

- Defined benefit (including hybrid) schemes;
- Defined contribution schemes; and
- Small fully-insured defined contribution schemes.

The Regulator will be releasing additional modules on its Trustee Toolkit in due course but you may also want to consider your wider training needs as a trustee, to ensure that you satisfy the revised scope.

Internal Controls

We expect that the Regulator will release the draft revised Internal Controls guidance during November for consultation. It is likely to adopt a more prescriptive approach with the emphasis placed on:

- Undertaking a thorough risk analysis and implementing an ongoing process for risk management;
- Taking professional advice if the trustee body does not include trustees with the necessary skills; and
- Keeping to certain minimum standards in the future.

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.

Seminar dates

Full Day Course	2009/10 Dates
Introduction to Trustees' Responsibilities	5 Nov, 9 Dec 2009 20 Jan, 23 Feb (Birmingham), 3 Mar, 20 Apr (Birmingham), 22 Apr, 26 May, 9 Jun (Birmingham), 8 Jul, 1 Sep, 14 Sep (Birmingham), 7 Oct, 3 Nov, 16 Nov (Birmingham) 9 Dec 2010
Essentials for DB Trustees	18 Nov 2009 24 Mar, 11 May (Birmingham), 23 Jun, 29 Sep, 26 Oct (Birmingham), 17 Nov 2010
Investment Essentials for DB Trustees (half day)	19 Nov 2009 25 Mar, 24 Jun, 30 Sep, 18 Nov 2010
Essentials for DC Trustees	10 Feb, 9 Mar (Birmingham), 12 May, 6 Jul (Birmingham), 15 Sep 2010
PMI Award in Pension Trusteeship (2 days)	21/22 Oct (full) 24/25 Feb 2010 This course is held in Woking

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

2009 Teleconferences 26 November

Our November teleconference will discuss the responses to our survey of employers and trustees on their approach to funding, along with possible solutions to dealing with a pension deficit in today's economic climate.

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

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