HYMANS ROBERTSON

Current issues

November 2018

Articles this month:

Budget 2018: pensions aspects

The Chancellor of the Exchequer delivered his 2018 Budget to Parliament on 29 October 2018 (at 3.30pm, much to the consternation of journalists working to deadlines).[1] His speech contained more jokes than pensions-related announcements.

Enabling DC investment in 'patient capital'

Her Majesty's Treasury (HMT) is taking steps to remove barriers to investment in UK innovative firms and infrastructure projects by defined contribution (DC) pension schemes.[2] The Pensions Regulator has revised its guidance to mention the potential benefits of an allocation to such 'patient capital' investments as part of a diversified portfolio, and summarizing the considerations that trustees ought to bear in mind when assessing their suitability.[3]

The Financial Conduct Authority (FCA) will produce a consultation document on possible changes to the list of approved assets that can be referenced by unit-linked investment funds, and a discussion paper on patient capital investment by authorized funds.

The Department for Work and Pensions (DWP) will conduct a consultation exercise in 2019 on possible changes to the charge cap that applies to the default investment arrangements in DC schemes, to ensure that it does not unduly restrict the use of performance fees.

Cold-calling ban

The DWP has reported on the outcome of a consultation exercise on the implementation of the long-promised ban on pensions cold-calling.[4] A revised draft of the amending legislation, which it intends to lay before Parliament shortly, is included as an annex.

The Government still intends to limit the statutory right to transfer to reduce the likelihood that pension rights will be transferred to fraudulent schemes. However, no date is given for the next steps in implementing such a change.

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[1] The text of his speech is at <www.gov.uk/government/speeches/budget-2018-philip-hammonds-speech>, and the full *Budget Report* is at <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752202/Budget_2018_red_web.pdf>.
[2] <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752193/Financing_growth_in_innovative_firms_one-year_on_PDF.pdf>.
[3] *A Guide to Investment Governance* <www.thepensionsregulator.gov.uk/docs/dc-investment-guide.pdf>.
[4] <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752005/regulations_to_ban_pensions_cold_calling_consultation_response_web.pdf>.

HMRC to have preferential ranking in employer insolvencies

Her Majesty's Revenue and Customs (HMRC) is to be given priority in insolvency situations, in relation to various taxes that employers are obliged to collect and pay over on behalf of other taxpayers (e.g. VAT, PAYE, employee NICs). This will take effect from April 2020.

Dashboard design

The DWP will consult '*later this year*' on the detailed design for Pensions Dashboards.

Public sector

The Chancellor confirmed that the provisional results of valuations of the unfunded public-service pension schemes suggest that benefit improvements will have to be made with effect from 2019/20, and that the SCAPE[5] discount rate used to calculate employer contributions has been reduced. The Budget Report outlines the support that is being provided to the government departments to ensure that the resulting additional costs do not put public services in jeopardy.

Self-employed pensions

The DWP will also '*this winter*' publish a paper on the Government's plans to get the self-employed saving for retirement.

Lifetime allowance

It was confirmed that the lifetime allowance for 2019/20 will be £1,055,000.

Termination payments

Plans to reform the treatment of termination payments, by making any excess over £30,000 (including non-contractual payments in lieu of notice) subject to employer National Insurance Contributions (NICs), will not now take effect until April 2020.

Price inflation

The Government says that it will, eventually, use as its main measure of inflation the variant of the Consumer Prices Index that includes owner-occupiers' housing costs (CPIH). No new uses of the Retail Prices Index (RPI) will be introduced, and it will move away from its existing uses of the RPI '*when and where practicable*'; it says that the complexity involved will mean that changes are likely to occur over an extended period of time.

Investments in infrastructure and private equity offer the potential for additional returns (vital in the early stages of DC investment) and help to diversify portfolios—a key component of managing risk. However, the ambition to mobilize DC savings for investment in growing businesses should be viewed cautiously where it involves start-ups, given that over 80 per cent of them fail. In DC members carry all the risk, and the last thing we need is for a high-profile failure to damage confidence in the industry. A review of the charge cap makes sense if the Chancellor want to increase the allocation to illiquid assets, which are expensive to transact and manage.

The plan to make HMRC a preferred creditor in business insolvencies will mean that it leapfrogs over occupational pension schemes in the priority rankings, worsening their positions in some cases.

The CPIH already inhabits the top spot in the Office for National Statistics' consumer price inflation bulletins. The annual rate of inflation based on the CPIH measure has tended to be around 20 to 30 basis points below the equivalent CPI rate over the last year.

[5] Superannuation Costs Adjusted for Past Experience.

Judge says GMP equalization is obligatory

A High Court judge has ruled that the trustees of UK defined benefit pension schemes must compensate members for differences attributable to guaranteed minimum pensions (GMPs).[6]

What is a GMP?

From 6 April 1978 to 5 April 1997, sponsors of DB pension schemes were able to make their employees 'contracted out' of the earnings-related aspects of the State pension, ensuring that both employer and employee paid lower National Insurance Contributions, as long as the schemes provided a 'guaranteed minimum pension'. In broad terms, the GMP replaced and replicated the State Earnings Related Pension Scheme (SERPS): however, there were some differences, notably in the details of pre-retirement revaluation and post-retirement increases.

Why are GMPs unequal?

Pensionable age, for GMP purposes, is 65 in the case of a man, and 60 in the case of a woman. The GMP for a woman will accrue faster, be revalued less, and be in payment for longer than that of a man with the same dates of birth and death. When compared with the benefits in excess of GMP that have accrued in defined benefit schemes over the same period, a GMP will typically be revalued more generously, pre-retirement; but it could increase at a higher or lower rate once in payment (there being no statutory requirement to increase 'excess' pension accrued before 6 April 1997, this detail will vary from scheme to scheme).

The combined effects of GMP inequality can mean that a particular member's pension is lower at any point than it would be if he or she were of the opposite sex; they can also mean that the position is reversed at a later date, putting the same member in the 'advantaged' category.

Why was there a court case?

The principle that men and women should receive equal pay for equal work extends to the benefits paid to employees under occupational pension schemes. That was established by the famous *Barber* judgment[7] on 17 May 1990 (which became the backstop date for equalization claims) and developed in subsequent court decisions. Ever since, there has been debate about whether and how the principle applies to GMPs, which occupy an unusual position as a quasi-State benefit. Since 2010, successive UK Governments have held to the view that any inequalities resulting from GMP differences in benefits accrued since *Barber* should be removed (regardless of whether a disadvantaged person can identify an opposite-sex comparator).[8] All legislative and other initiatives intended to settle the matter have, however, fallen by the wayside, and some commentators continue to question the need for such equalization.

Against that backcloth of uncertainty, Lloyds Banking Group, the trustees of its pension schemes, and a trade union representing its employees agreed to refer the matter to the High Court.

What was the Court asked?

The main questions put to the judge were—

- Does the law require equalization for GMP differences?; and
- If so, is there a single correct method of doing it; or do the trustees have a choice of acceptable methods?

The parties to the litigation put forward (broadly) four equalization methods. Roughly summarized, they involve:

A. separately considering, and where necessary equalizing, each feature of the pension (GMP and non-GMP), annually;

B. annually, calculating the member's pension and what it would be if that member were of the opposite sex, and paying the higher of the two;

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[6] *Lloyds Banking Group Pensions Trustees Limited v Lloyds Bank PLC and Others* [2018] EWHC 2839 (Ch).

[7] *Barber v Guardian Royal Exchange Assurance Group* (C-262/88).

[8] *Hansard*, House of Commons, 28 January 2010, Column 66WS <https://publications.parliament.uk/pa/cm200910/cmhansrd/cm100128/wmstext/100128m0001.htm#10012850000017>.

C. performing the same annual comparison as in Method B, but keeping a running total of pension paid, so that a member who has benefitted from equalization increases is not overcompensated if the advantaged and disadvantaged sexes later swap places; and

D. valuing the benefits of the member and the opposite-sex comparator actuarially, at a single point in time, then paying the difference to disadvantaged members in the form of an actuarially calculated pension increase.

In anticipation of a decision that equalization was necessary, the judge was asked some supplementary questions, most notably:

- whether there is a limit on how far back the trustees might have to go in equalizing past instalments of pensions in payment;
- whether they should pay interest on those under-payments; and
- the implications for past transfers (both inward and outward).

The ruling

Although the ruling was about the specific pension schemes involved, the judge recognized that his ruling would be widely applicable. He said that the trustees in the case are legally obliged to equalize overall benefits to eliminate the disparities produced by GMPs. The methods advanced were all, in one form or another, legally acceptable means of achieving equalization. However, the 'principle of minimum interference' meant that, unless the employers consented to a more-costly, alternative calculation, the trustees would be required to adopt a variant of Method C above: year-on-year calculations, but offsetting any accumulated 'gains' made through equalization against later payments, to avoid overcompensation.

The judge went on to rule that equalization payments for pensioners should be backdated. Their claims to arrears are not subject to a statutory limitation period; but they could be restricted under a specific scheme's rules. He said that the backdated payments should be made with simple interest at 1 per cent over the bank base rate.

Consideration of some issues has been deferred. One such question is whether the trustees could adopt a different process for members for whom the estimated costs of equalization are disproportionate to the value of the additional benefits that they stand to gain. Another is whether the trustees have any obligations in relation to benefits that have been transferred out of their schemes (the judge held that transferred-in benefits must be equalized).

It is possible that additional questions will be asked of the Court, or that one of the parties involved will seek permission to appeal. Even allowing for that, it will take a while to resolve the implications of the judgment, especially with so many schemes in the process of reconciling their GMP records. Areas for consideration include:

- *funding valuations and cash contributions*—extra liabilities will need to be quantified, and will worsen the funding position, perhaps requiring extra cash contributions;
- *administration and member payments*—as well as uplifts in respect of historical payments, schemes will need to consider the implications for payments including transfer values, trivial commutation and upcoming retirements;
- *communicating with members*—schemes may want to update members, as they are likely to have many questions as a result of press coverage of the case;
- *buy-ins and buy-outs*—schemes that have undertaken or are undertaking a buy-in or buy-out will need to consider how to deal with the potentially higher pensions;
- *investment decisions*—if GMP equalization causes a step change in the funding position, de-risking triggers and investment strategies may need to be reviewed (trustees may also want to look at the impact on liability-driven investment (LDI) benchmarks, particularly those with high levels of hedging); and
- *corporate accounting*—the assessment and treatment of extra reserves will need to be considered, and it is possible that this change could go through Profit and Loss (P&L).

PPF response to Hampshire ruling

The Pension Protection Fund (PPF) has announced details of its response to September's *Hampshire* ruling.[9] It plans to increase compensation payments in advance of any legislative changes arising from the judgment, and is working with the Department for Work and Pensions (DWP) to ensure that the two bodies' approaches are consistent. It expects that the number of members who are affected will be '*very small*'.

In *Hampshire*, the European Court of Justice (ECJ) said that the members of schemes for which the PPF assumes responsibility must receive compensation worth at least 50 per cent of the value of their accrued scheme benefits.[10] The case concerned a pensioner who, through the action of the PPF's compensation cap and other rules, is currently receiving around a quarter of the pension to which he was entitled under the rules of his occupational pension scheme.

The PPF has begun writing to those currently in receipt of capped compensation whom it believes are affected by the ruling. It needs to fill gaps in the information that it holds for those persons in order to calculate the compensation increases that are due to them. It will subsequently contact those for whom the impact will be further into the future, such as members who are nearing retirement age, and the trustees of schemes that are undergoing PPF assessment.

Its calculations will involve comparison of the values of members' expected scheme benefits, and the usual PPF compensation, at the point when the PPF's assessment of the scheme was triggered (generally by employer insolvency). If the value of the PPF compensation is less than 50 per cent of the value of the expected scheme benefits, the rate of the PPF's compensation will be raised until its value reaches the halfway mark. The intention is that this will be a one-off adjustment that will take into account the PPF's rules for revaluation in deferment and increases in payment.

A similar process will be applied in relation to the Financial Assistance Scheme for those affected by employer insolvency prior to the advent of the PPF.

It seems that what is planned is something like a pension increase exchange (PIE) exercise: members will be (involuntarily) swapping their prospective scheme increases for PPF benefits. The value comparison means that affected members are likely to start out with PPF compensation in excess of 50 per cent of the scheme pension that they stood to receive, to take account of lower increases under the PPF rules. However, those who live a while in retirement could find that their PPF compensation in later years is below half of what their scheme pensions would have been. Will they sue?

The PPF's announcement is silent about the effect on scheme levies, and what it intends to do about past assessments. We anticipate that any levy increase will be modest for most schemes, but the calculations are potentially complicated. We hope that the numbers involved are small enough that the PPF will not feel the need for substantial revisions to the methodology for the 'section 179' valuations that are used for levy purposes; there will probably be more work to be done for 'section 143' valuations when schemes are assessed for entry into the PPF.

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[9] <www.pensionprotectionfund.org.uk/News/Pages/details.aspx?itemID=499>.

[10] *Hampshire v The Board of the Pension Protection Fund* (Case C‑17/17). See *Current Issues* October 2018 for a summary of the judgment <www.hymans.co.uk/news-and-insights/research-and-publications/publication/current-issues-october-2018/>.

Improving the quality of DB pension transfer advice

The Financial Conduct Authority (FCA) has announced several policy changes designed to improve the quality of pension transfer advice.[11] They add to the qualifications that must be held by specialist transfer advisers, and the details of the work that they are expected to undertake when giving advice, as well as clarifying the geography of the border between 'guidance' and 'advice'. The FCA continues to explore the strength of the case in favour of banning contingent charging arrangements.

Background

The FCA's latest Policy Statement is the outcome of a consultation exercise begun in March 2018.[12] [13] It was motivated by the unprecedented levels of transfer activity since the Freedom and Choice reforms in 2015: it estimates that 100,000 members are transferring out of DB schemes annually, taking assets of 20 to 30 billion pounds with them. It is concerned about the quality of the financial advice received by some members, a problem that was starkly exposed by the highly publicized cases of some people who were persuaded to transfer out of the British Steel Pension Scheme during a restructuring exercise. In the aftermath some financial advisers experienced such difficulty in obtaining professional indemnity insurance that they have decided to stop offering transfer advice. This could make it difficult for scheme members to obtain such advice, which is compulsory for those with transfer values in excess of £30,000.

The FCA hopes to improve the quality of transfer advice, and the functioning of the advice market, by clarifying what it expects from advisers. Having considered the responses to the consultation exercise, the FCA has decided to proceed with all but one of its proposals (it has postponed its plan to revise the definition of a 'pension transfer' to encompass the terminology now used in the transfer legislation whilst it reconsiders how best to achieve the intended '*simplification and clarity*').

Qualifications

If they are to continue to practice from 1 October 2020 onward, Pension Transfer Specialists (PTSs) will, in addition to their existing qualifications, need to become qualified to provide investment advice (if they are not already). This stems from the expectation that a PTS ought to consider the advice in its entirety (see below). The FCA will also revise the examination standards for the PTS qualification to take account of changes such as the Freedom & Choice reforms.

Triage

The FCA has become concerned that some advisers are providing regulated advice during 'triage services': preliminary discussions with prospective clients to equip them to decide whether to proceed and obtain advice. With effect from 1 January 2019, new guidance for such advisers will say that '*triage should be educational and provide generic, balanced information on the advantages and disadvantages of a pension transfer*'. If the implications of the client's personal circumstances are raised in a way would tend to steer them one way or another, it is likely that the discussion has crossed the boundary into advice. If a regulated advisor provides a client with a 'transfer value comparator' (a graphical illustration of the value of the member's DB rights) during triage, that too is likely to constitute advice.

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[11] PS18/20, <www.fca.org.uk/publication/policy/ps18-20.pdf>.
[12] CP18/7: *Improving the quality of pension transfer advice* <www.fca.org.uk/publication/consultation/cp18-07.pdf>.
[13] You can read our consultation response at <www.hymans.co.uk/media/uploads/Hymans_Robertson_Response_to_FCA_Improving_the_quality_of_pension_transf....pdf>.

Advice process

The following changes were effective immediately on publication of the Policy Statement on 4 October 2018:

- the FCA will continue to allow non-PTS advisers to give transfer advice, provided that their advice is checked by a PTS before being communicated to the client;
- it will also remain possible for a PTS to advise on the transfer out of the DB scheme whilst a separate adviser covers the receiving scheme and its investments; however, the FCA is amending its rules to clarify how they should operate;
- reacting to evidence that some advisers were making incomplete or biased assessments of their clients' attitudes to risk, the FCA has revised its guidance to require a more rounded and rigorous risk evaluation; and
- advisers are now required to provide suitability reports even when transfer is not recommended (that is, they will have to advise the client not to transfer, and explain why not).

Contingent charging, etc.

The FCA will carry out further work on the different charging structures used in pension transfer advice, and in particular contingent charging, as a result of the responses it has received to its consultation and because of the significance of the issues. If it concludes that changes are needed, it will consult further on any new proposals in the first half of 2019. The FCA reminds financial advisers, in the meantime, about its policies on charge disclosure and conflicts of interest.

The FCA is also speaking to Her Majesty's Revenue and Customs (HMRC) about a quirk of the VAT rules that was highlighted in consultation responses as a possible incentive to use certain charging models (the gist of the concern is that advice fees seem to be exempt from VAT only if a transfer goes ahead).

A number of the changes feel like good common sense, and we expect that a significant number of reputable advisers are already adopting them. Nonetheless, the additional clarity will be welcomed by the industry and, overall, should serve to improve outcomes for members, something we are highly supportive of.

The deferral of a decision on contingent charging has grabbed the headlines. The FCA is clearly trying to avoid a knee-jerk reaction that could make it very difficult for some members to access affordable advice. At the same time, it is keen to understand whether there is a link between charging practices and quality of advice. To instil confidence in the advice market, it feels like further clarity is needed here, and quickly.

Contingent charging structures are closely linked to the 'guidance vs advice' boundary. The FCA feels that too many advisers are crossing the boundary in their triage services, so that change is needed. This is likely to mean that more members need to obtain (and pay for) full advice only to realize that staying in the scheme is the right thing for them to do. This in itself could lead to a move away from contingent pricing models, or else advisers will be doing far more work for the same remuneration.

Trustees and sponsors have a valuable role to play here in ensuring that members have access to balanced and engaging information on their retirement options, to better prepare them for decision making. By facilitating access to financial advice, trustees and employers can ensure that members are able to access good-quality advice, at transparent cost, when they most need it.

And Finally…

It's that spooky time of year again, and that's really the only excuse that *AF* can muster for mentioning the title of the recent *AssetTV* video, *Are FAANG stocks behind growth's rally?* Any readers galvanized by the prospect of finally proving their theories about vampiric meddling in investment markets (after all, you can't get much more long-term than un-dead) will have their dreams swiftly and cruelly dispelled: [*Spoiler Alert*] FAANG stands, anti-climactically, for Facebook, Apple, Amazon, Netflix & Google…

The phrases 'toilet humour' and 'potty mouth' were given a new twist by an unexpected source this week, as Chancellor of the Exchequer Philip Hammond delivered a succession of latrine-themed puns in celebration of his Budget 2018 announcement of a new form of, er, relief for those providing publicly accessible lavatories. (Disappointingly, Phil's *not* a privy counsellor.) The unconventionally timed Budget—*3:30pm? On a Monday?*—was relatively free of shocks, and therefore, as he noted, deprived tabloid headline writers of the opportunity of making seasonally apposite references to '*Hammo's House of Horrors*'…