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Changes could send pensions in wrong direction

Given that the Budget was expected to have little to say on pensions, it was a surprise when Chancellor of the Exchequer George Osborne announced potentially far-reaching changes to retirement income rules.

Under the banner of 'freedom and choice at retirement', he is changing the tax rules to make it easier to take more or even all of a defined contribution pension pot in a lump sum at or during retirement.

This was in contrast to previous efforts to build consensus around pensions changes and has raised concerns that the changes could undermine people's ability to provide adequately for their retirement.

TUC General Secretary Frances O'Grady said: "Pulling big announcements out of the Budget hat is not the way to make pensions

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Welcome

Contrary to all expectations at the beginning of the year, 2014 could herald yet another major overhaul of the UK pension system. While some of these changes are welcome, including legislation that will permit the introduction of Collective Defined Contribution (CDC) schemes, others pose challenges, such as replacing a dysfunctional annuity system with something of a vacuum. It remains to be seen if and how the CDC proposals are compatible with the Budget changes.

Meanwhile, in the ‘business as usual’ corner, automatic enrolment has now passed the three million mark, and the National Employment Savings Trust (NEST) boasts more than a million members. It will be very interesting to see how NEST will amend its investment strategy in the light of the Budget changes. This will be watched by other trustees.

In the ‘one to watch’ category comes the revised Institutions for Occupational Retirement Provision (IORP) directive which, if not significantly amended, could threaten the role of even the most experienced lay trustees.

Finally, we are delighted to welcome the TUC’s new policy officer for pensions and investments, Tim Sharp. He said: “It is exciting to be taking on this role at a time when pensions policy in this country is at such an important crossroads. It is vital that recent progress is not undermined by headline-grabbing initiatives unveiled for short-term political gain.”

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policy, and breaks with the real efforts to build consensus by both the previous government and this one.

“Some of the Chancellor’s changes, such as increasing the size of small pension pots that can be taken as cash lump sums, make sense and were already well supported by those interested in pensions. But the main thrust of the Chancellor’s policy goes against what most people want from the pension system – a decent income in retirement. As no-one can know how long they will live, this is best achieved by sharing risk in collectively organised pension schemes.”

In its response to the Treasury’s consultation on the Budget proposals, the TUC noted that the failings of the current annuities system are now well understood.

But it argued that the Budget failed to put forward any proposals that would provide what most people want in retirement – a secure and predictable income.

“Traditional annuities may have had their day and be too restrictive, but what we need for decumulation is the same as we are building for accumulation – good default strategies with consumer safeguards built in. It is economically efficient to build in risk-sharing and risk-pooling into the decumulation process,” the TUC said.

The Budget announcements pose many challenges for trustees, and the Pensions Regulator has produced a statement to help trustees understand the impact on their scheme. The statement outlines some of the proposed changes, including the removal of tax restrictions on the way that members draw their defined contribution benefits at their normal retirement date.

This change, which is subject to consultation, would mean that from April 2015 a member could, where scheme rules allow, withdraw their entire pot as cash. A 25 per cent tax-free lump sum would still be available, with the remainder of the pension being subject to tax at the member’s marginal rate.

The Regulator warned that trustees should consider taking advice on the implications of the Budget 2014 announcement as its impact will vary depending on scheme rules, and that trustees should also consider how communications to members might be affected. The full statement can be found at **www.thepensionsregulator.gov.uk/docs/statement-dc-budget-2014.pdf**

NEST, the National Employment Savings Trust, has announced an overhaul of its investment strategy due to the proposed changes. It will review the approach taken in the final ‘consolidation’ phase of its Retirement Date Funds to ensure it matches members’ planned methods of taking retirement benefits.

TUC General Secretary Frances O’Grady said that the changes announced in the Budget went against sharing risk in collectively organised schemes

New DB funding code published

The Pensions Regulator has published a new code of practice to help trustees and sponsoring employers of defined benefit (DB) pension schemes to agree funding plans that provide security for retirement savings while enabling employers to invest in sustainable growth. The code is part of a significant change in the Regulator's approach to DB schemes. It recognises that a strong sponsoring employer alongside an appropriate funding plan provides the best support for a well-governed scheme. The code is expected to come into force later this year, following the parliamentary process.

The code urges trustees and employers to work in a collaborative and transparent way to consider the impact scheme funding proposals may have on the employer's plans for sustainable business growth. It also recognises that risk is inherent in pension schemes and expects trustees to identify and manage the key areas of investment, funding and employer covenant.

Interim Chief Executive of the Pensions Regulator, Stephen Soper, said: "The revised DB funding code and strategy set out our expectations of trustees, and how we will balance our current member and Pension Protection Fund (PPF) protection objectives with our new objective to minimise any adverse impact on the sustainable growth of an employer. In the vast majority of circumstances, trustees and employers should be able to agree funding plans that both benefit the business and strengthen the scheme's long term security."

The Regulator has also published its third annual funding statement, which provides direction for schemes with valuation dates between September 2013 and September 2014.

Alongside the new code, the Regulator has also published guidance for trustees, setting out nine broad principles:

- Trustees and employers should work together in an open and transparent manner.
- Trustees should manage funding, covenant and investment risks in a way that takes account of how they interact with each other.

» Employers should be able to agree funding plans that both benefit the business and strengthen the scheme's long-term security. «

- Trustees should assess their employer's ability to help their scheme if risks materialise.
- Individual decisions in a scheme should be consistent with the trustees' long-term targets and their view of the employer's strength.
- The approach trustees use should be in proportion to the size, complexity and level of risk in their scheme.
- Trustees should seek appropriate funding that reflects a reasonable balance between the need to pay promised benefits and minimising any adverse impact on an employer's sustainable growth.
- Trustees should run their scheme in line with good governance standards.
- The scheme should be treated fairly when compared to other creditors of the employer.
- Any deficit should be paid off over an appropriate period.

The code, guidance and associated material can be found at **www.thepensionsregulator.gov.uk/db-pensions.aspx**

Stewardship update

A resolution demanding that bus and rail group National Express improve its oversight and reporting of human capital policies and practices received substantial backing at its annual investor meeting. The vote followed numerous reports from the US that the company seeks to frustrate employees' right to representation by a trade union and was the culmination of prolonged engagement by both UK pension funds and US trade union members with the company.

Those of you for whom we have an e-mail address will have a received a letter in April from TUC General Secretary Frances O'Grady asking you to support the resolution. It was co-sponsored by three UK local authority pension funds – Greater Manchester Pension Fund, Nottinghamshire Pension Fund and the London Borough of Islington Pension funds – as well as the Teamsters union, and 100 individual National Express shareholders, many of whom were also company employees.

The motion won the highest level of voting support of any resolution addressing social and environmental issues filed with a UK listed company in the last ten years. The vote in favour was almost 13 per cent and, including abstentions, the total votes not supporting management was just under 15 per cent. Stripping out the 89 million shares held by National Express director Jorge Cosmen, 19 per cent of investors withheld their support from the board's stance.

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The fourth report by the Investment Management Association (IMA) on adherence to the Financial Reporting Council's Stewardship Code, published in May, has found a significant increase in asset managers' resource for engagement with companies, and that nearly all report to their clients on their stewardship activities. The report included case studies providing evidence of the impact of engagement on corporate behaviour, and can be found at **www.investmentuk.org/research/stewardship-survey**

Another report, by Standard Life Investments and Tomorrow's Company, *Building the Momentum for Effective Investor Stewardship*, called for the industry to go beyond the minimum standards set in the Stewardship Code. The study identified an uneven understanding of stewardship and its importance throughout the investment chain. Other issues highlighted included limitations in the view that many investment consultants have of their roles, and the closure of defined benefit schemes resulting in the dispersal of decision-making to millions of individuals.

The report is available at **http://pdf.standardlifeinvestments.com/exported/pdf/email_links/CO_Building_Momentum_Paper_M02_14.pdf**

Meanwhile, more than 50 asset managers have completed the Stewardship Disclosure Framework set out by the National Association of Pension Funds (NAPF), representing some £10.5trn of assets under management. NAPF Chief Executive Joanne Segars said that despite many people signing up to the Stewardship Code, a number of signatories are yet to complete a framework, including some 15 of the largest asset managers. "Inevitably, this raises questions about their willingness to give transparency in this crucial area. It is hard to imagine why an asset manager would not want to disclose their stewardship credentials to existing and future clients," she said.

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Responsible investment round-up

Not-for-profit organisation, The Carbon Tracker Initiative, has published the first in a series of reports, *Carbon Supply Cost Curves – Evaluating financial risk to oil capital expenditures,* which is intended to assist investors in engaging with companies about carbon asset risk. It introduces the concept of a carbon supply cost curve to global oil projects – highlighting that many make neither financial or carbon sense when stress-tested against demand, price and emissions scenarios. The report can be downloaded from **www.carbontracker.org**

The FTSE Group has launched its first set of benchmark indices that exclude companies operating in the fossil fuels market, following warnings over the financial risk of climate change. The FTSE Developed ex-Fossil Fuels Index Series, developed with fund management company BlackRock and the not-for-profit Natural Resources Defense Council, will omit companies linked to exploration, ownership and extraction of carbon reserves. FTSE Group Chief Executive Mark Makepeace said the indices were developed following client demand for investment options that “reflect their overall business culture and values”. Firms in the industry subsectors of exploration and production, integrated oil and gas, coal mining and general mining will be considered for omission.

Meanwhile, legal advice obtained by the Local Government Pension Scheme (LGPS) Shadow Scheme Advisory Board has advised that Local Government Pension Scheme funds may choose to take into account the public health implications of tobacco investment, but only if the result of such consideration is the replacement of these investments with assets producing a similar return.

The LGPS sought an opinion from Nigel Giffin QC on whether an LGPS administering authority owes a fiduciary duty and if so to whom exactly is it owed, and to advise on how the wider functions, aims or objectives of the administering authority should influence the discharge of its LGPS investment duties. Giffin said: “The administering authority’s power of investment must be exercised for investment purposes, and not for any wider ones. Investment decisions must therefore be directed towards achieving a wide variety of suitable investments, and to what is best for the financial position of the fund” but “the precise choice of investment may be influenced by wider social, ethical or environmental considerations, so long as that does not risk material financial detriment to the fund.”

Campaign group ShareAction welcomed the legal opinion, taking the view that it allows LGPS members to propose that their funds seek alternatives to tobacco that deliver the same long-term investment returns. The “ethical tie-break” was also endorsed in the report of the Law Commission review of fiduciary duties of investment intermediaries.

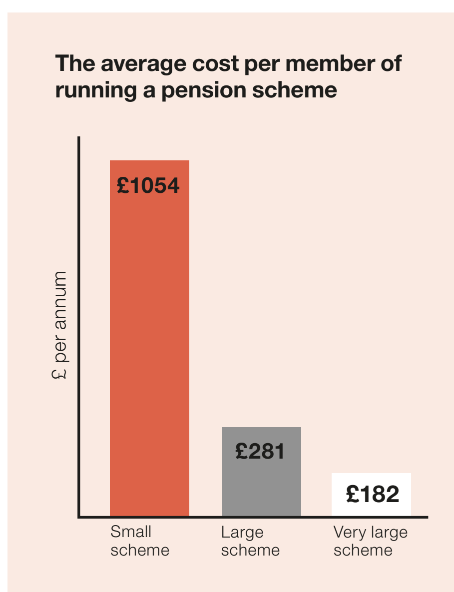
New tools from the Regulator to help trustees

In the last few months, the Pensions Regulator (TPR) has launched a number of new tools to help trustees in their work, as well as updating and improving the Trustee Toolkit e-learning site.

For trustees of defined benefit schemes, TPR has launched a charges checklist and a web tool to help trustees assess how the costs of their scheme compare with those of a typical scheme of a similar size. The information it provides should offer a starting point for trustees who wish to assess the value they get from their pensions professionals and service providers. The comparison tool and checklist, which can be found at **www.thepensionsregulator.gov.uk/trustees/db-scheme-costs-tool.aspx** follows research findings on administration and other running costs for DB schemes of different sizes. The research found that nearly a quarter of trustees could not identify what they were paying in investment charges, even though these represent the second largest expense for such schemes.

Key findings of the research include:

- The average cost per member of running a small scheme stands at £1,054 per annum – nearly four times higher than that for a large scheme (£281), and nearly six times higher than that for a very large scheme (£182).
- Scheme administration represents the greatest proportion of costs – 37 per cent on average, ranging from 41 per cent for small schemes, 31 per cent for large schemes and 35 per cent for very large schemes.
- Investment costs represent the second largest cost for schemes – 22 per cent on average, ranging between 20 per cent for small schemes, 27 per cent for large schemes and 43 per cent for very large schemes.



For trustees of defined contribution schemes, TPR has published a template for annual governance statements and an assessment model to help trustees complete the statement accurately. The regulator says that the governance statement should be easily available to members and employers – for example, by publishing it in the scheme's annual report and accounts, or on its website, and should be used to:

- confirm that the scheme complies with the requirements of the Regulator's DC code of practice, guidance and in particular that it exhibits the quality features
- explain where the scheme has adopted a different approach where a quality feature is absent or partly in place
- set out what action the trustees intend to take to correct the position where a feature is absent or improve an existing feature.

To help trustees to complete the governance statement accurately, TPR has also published a template to enable them to assess their scheme against the DC quality features. The template and other linked material can be found at **www.thepensionsregulator.gov.uk/trustees/checking-you-run-a-quality-dc-scheme.aspx#s11192**

TPR has also made available a new online tool for reporting late or non-payments of contributions. More information and access can be found at **www.thepensionsregulator.gov.uk/trustees/maintaining-contributions.aspx**

TPR has updated its trustee toolkit, a free online learning programme. The changes include:

- the introduction of four new models; two are for trustees of DC schemes, including one on investment
- restructured content to allow users to focus on modules relating to the scheme type they oversee
- rewritten tutorials, including the introduction of a charges glossary
- the creation of a learning needs analysis tool.

The toolkit includes modules and resources developed to help trustees meet the minimum level of knowledge and understanding required by the Pensions Act 2004.

Legal update

The High Court has upheld a challenge on behalf of some 5,000 pension scheme members to proposed changes to a defined benefit pension scheme at technology company IBM. In a long and complex decision, the Court held that IBM had been in breach of its duty of good faith to pension scheme members ("the Imperial duty", named after a previous case involving Imperial Tobacco) and also in breach of implied terms of the employment contract.

IBM tried to make wide-ranging changes to its final salary pension scheme, to the detriment of the scheme members, including closing defined benefit accrual and replacing it with a defined contribution scheme, replacing a permissive early retirement scheme with a more restrictive one, and making future pay increases non-pensionable.

The Court held that the employer had engendered reasonable expectations in the pension scheme members that their benefits would continue to accrue, subject only to the possibility of change if there was a significant shift in financial and economic circumstances; they had also been given a reasonable expectation that the more generous early retirement scheme would continue until at least 2014; and they had used this information to make important decisions about their lives. The fact that IBM would have trouble meeting targets for investors was not in itself sufficient to justify confounding the pension scheme members' expectations. On the evidence, the court found that the savings did not have to come from the pension scheme.

This is a potentially significant judgment, but such cases are fact-specific, in that the reasonable expectation of the scheme members is likely to be linked to the employer's particular conduct and communication to employees. The case is expected to go to appeal.

A recent ruling by the Court of Justice of the European Union on the treatment of holiday pay may have implications for the administration of pension schemes. In *Lock v British Gas Trading*, the Court ruled that an employee's holiday pay should include commission and other elements of variable pay. The Court held that employees who receive variable pay which is "intrinsically linked to their contract of employment" including overtime, shift allowances and offshore allowances should be paid basic salary plus contractual variable pay during periods of annual leave. If variable pay was not included and workers were paid significantly less during a period of annual leave then low pay could deter employees from actually taking their holidays. The decision has potential consequences for pension schemes: if scheme rules define pensionable earnings by reference to elements of variable pay, or provide that all pay is pensionable, incorrect figures may have been used for calculation of contributions and benefits.

Trustees of pension schemes that include variable or total pay in the calculation of pension benefits may wish to investigate with their sponsoring employer if there are any implications for their scheme.

Same-sex marriages

Same-sex marriages became legal in the UK at the end of March.

Pension schemes therefore need to consider what survivor benefits will be provided to same-sex spouses.

Under the Marriage (Same-sex Couples) Act 2013, where a legal agreement (such as a pension scheme's trust deed and rules) was entered into before the Act came into force, the provisions of the Act will not affect such an agreement. This means that references to "spouse" will not automatically include a spouse of the same sex.

However, schemes will still need to provide survivors' benefits for same-sex spouses to comply with their equal treatment obligations under the Equality Act. This requires same-sex partner benefits to be paid, but only in respect of service after 5 December 2005 (as for civil partners).

The Equality Act introduces an overriding rule into scheme rules that obliges schemes to comply with its requirements. However, if the scheme wishes to provide same-sex spouse benefits in respect of all service, rule amendments may be required.

The government is due to carry out a review of the law relating to same-sex survivor benefits by the end of the summer and therefore the legal position may soon change, but any such changes may not come into force for some time.

New IORP Directive threatens lay trustee governance

A new draft Directive from the European Commission on the activities and supervision of institutions for occupational retirement provisions (IORPs), known as the IORP II Directive, was published in March 2014.

The stated aims of the revisions are improving the governance and transparency of IORPs in Europe.

The proposals considerably lengthen the original IORP Directive, published in 2003, from 24 to 81 articles.

The proposals state that all IORPs must have "an effective system of governance which provides for sound and prudent management of their activities" and "an effective risk management system". The governance system should be proportionate to the nature, scale and complexity of the IORP's activities.

Whilst much of the Directive's approach to risk management ties in closely with the Pensions Regulator's approach, and arguably will not require major changes in scheme management in the UK, the Directive also includes proposals requiring that all persons who run an IORP must have the "professional qualifications, knowledge and experience" to enable them to ensure the sound and prudent management of the IORP and to carry out their key functions.

This is contrary to the UK's existing system of lay trustees and could lead to many trustees, both employer- and member-nominated, being forced either to take professional qualifications or to resign from the trustee board. There is a risk of a great loss of expertise from UK trustee boards and a diminished level of member input.

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Hermes Fund Managers' published *ESG Investing – Does it make you feel good, or is it actually good for your portfolio?,* which reported that companies with good corporate governance deliver 30 basis points per month higher returns on average than those with poor oversight arrangements. The findings suggested that environmental, social and governance (ESG) investment strategies can deliver quantifiable benefits. Hermes uses board independence, shareholder rights plans (or 'poison pills'), remuneration, independent directors, split chief executive and chairman role, risk management, business ethics and proxy voting in assessing governance risk factors.

» ESG investment strategies can deliver quantifiable benefits. «

However, while governance ratings were a useful indicator of shareholder returns in Asia and Europe, the report noted that it is less helpful to assess holdings in North America, where markets "are subject to more robust regulation and companies are at higher risk of litigation", and so firms in the region are generally governed to a better standard, Hermes said.

The report also found that although there were clear benefits from targeting companies with good governance, the impact of environmental and social factors on shareholder return could not be demonstrated, but noted that as more data becomes available, and more asset owners focus on environmental or social considerations, this may change.