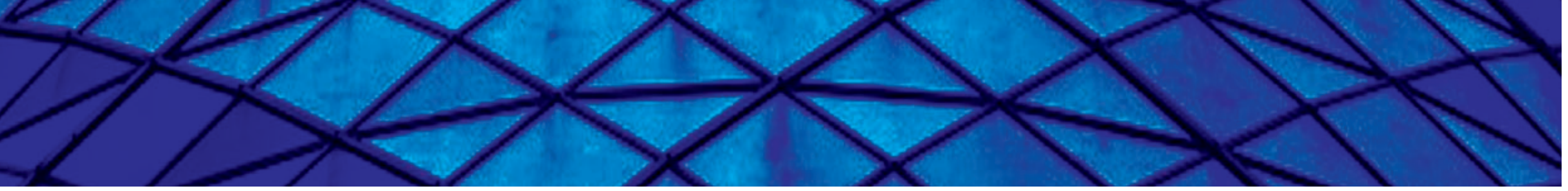
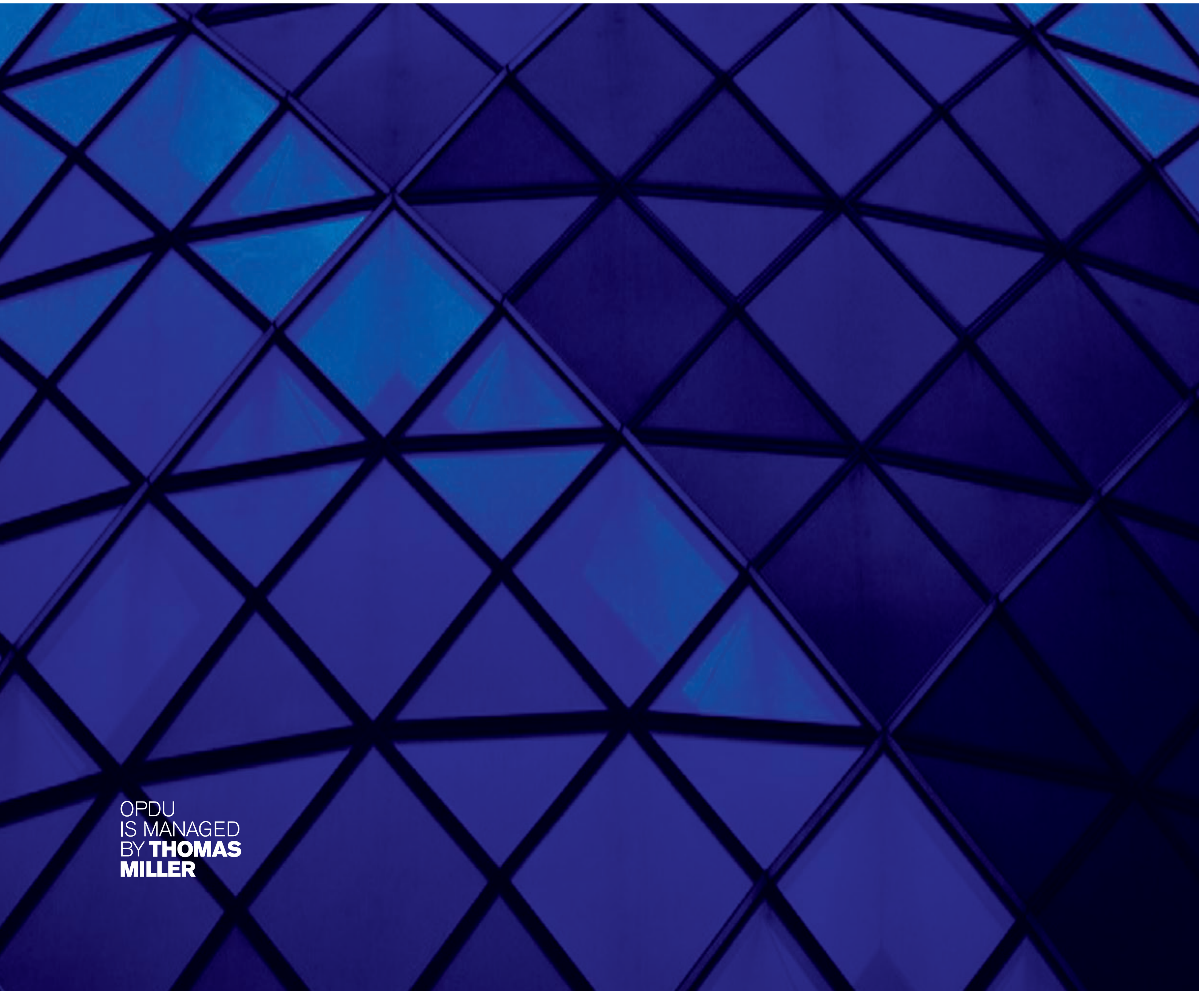


OPDU

Report 29

Protecting Trustees Pension Schemes and Sponsoring Employers



Report 29

OPDU

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Chairman's Comments

This edition of the OPDU Report features articles by the speakers at OPDU's Annual Risk Conference last March.

The keynote speech given by Robert West of Baker and McKenzie LLP focused on the main risks faced by pension schemes and trustees and how these have increased over the years. The Conference then focused on the biggest single risk facing DB Schemes and their members, employer covenant risk and how this can best be measured and managed.

The Conference then moved on to the "Do's and Don'ts" of investment both from the perspective of DC schemes and DB funds. Bill Galvin, Chief Executive of The Pensions Regulator then told us what the Regulator expects from schemes and their trustees. Our session in pension scheme administration focused on common problems, how to address them and how to improve standards. The final session reviewed "What can go wrong – The lessons from Claims", "Do's and Don'ts for Companies and Trustees" and the various protections for trustees against claims. Indemnities, exoneration clauses, the protection offered to directors of corporate trustees and statutory protections are all valuable protections for trustees against claims but they cannot always protect trustees in all circumstances. Even when trustees are protected, they may have to incur very substantial legal expenses to avoid personal liability or in protecting the scheme assets. Also even when trustees are protected, the costs of losses involved in these claims may then fall on the scheme or the sponsoring employer, or else on members whose justifiable claims may not be met in these circumstances. A well designed insurance policy sitting in front of these other protections will protect the trustees and also the legitimate interests of schemes, sponsoring employers and members.

As I write this piece in late September equity markets have plummeted, bond prices and therefore liabilities and annuity prices have risen. Trustees and sponsoring employers have found the funding levels of their DB Schemes have fallen significantly unless assets have been matched with liabilities. Members retiring from DC Schemes are likely to receive significantly lower pensions. The pension world is full of risks!

On 1st March 2012 OPDU, with its underwriters ACE, will be holding its next Annual Risk Conference. There will be much to discuss! I look forward to seeing many of you there.

Peter Murray
Chairman
OPDU Advisory Council

OPDU Member successes at the Professional Pensions Pension Scheme of the Year Awards 2011

Our congratulations to OPDU member the **Railways Pension Scheme** for winning the Premier Scheme of the Year (over £2.5bn) and also to **SAUL The Superannuation Arrangements of the University of London** for its multiple awards: Large Scheme of the Year (over £1bn-£2.5bn); best DB Investment Strategy and Best Administration.

New cover enhancements to the OPDU Elite Policy

OPDU regularly reviews its policy wordings with its underwriters ACE to ensure that it continues to provide the most extensive insurance cover available designed to protect the personal liabilities of trustees and the assets of the pension scheme and sponsoring employer.

Accordingly, new enhancements of cover will be introduced shortly including importantly, extending the protection provided for retired trustees from 12 years to lifetime cover. This will provide individual trustees with valuable peace of mind in their retirement when they no longer have any say in whether their pension scheme should purchase insurance cover.

Full details of the new policy will be announced in November and circulated to OPDU Members.

Access is also given to OPDU's specialist services which include a professional claims handling service provided by a team of in-house lawyers and pension professionals who deal with claims in a sympathetic manner in conjunction with your own advisors. OPDU also provides advisory and risk management services including a confidential advice line for trustees and administrators.

OPDU is pleased to assist whether your insurance needs relate to a current scheme or one that is being wound-up and the trustees and employer require discontinuance or run-off.

Dates for your Diary

Your invitation to OPDU ANNUAL MEETING - Thursday 26 January 2012 at 5pm

We are delighted to announce that Lawrence Churchill CBE, Chairman, NEST will be addressing our Annual Meeting. A further speaker will be announced shortly.

The Directors of OPDU request the pleasure of your company at Reed Smith, Broadgate Tower 20 Primrose Street London EC2A 2RS (close to Liverpool Street station)

- The meeting will commence at 5pm with registration 4:30pm.
- The meeting will be followed by a wine and buffet reception.
- All readers are welcome to attend and can register online at **www.opdu.com**

Thursday 1 March 2012 CBI Centrepoint OPDU/ACE ANNUAL PENSION RISK CONFERENCE

Register your interest online at: **www.opdu.com**

Feedback from our previous conferences:

"I would say your conference was one of the best I have ever attended. From beginning to end it commanded attention and had a wonderful relaxed atmosphere about it whilst at the same time containing some very informative and thought-provoking content."

Conference features:

- Addressed by leading industry experts
- Attended by pensions professionals from all sectors
- Panel debate and ample time for questions
- Programme and speakers to be confirmed shortly

Who should attend?

Trustees, pension managers, finance directors, HR directors and advisors to pension schemes and sponsoring employers. Eligible for Continuous Professional Development points

THERE IS NO CHARGE TO DELEGATES

The Conference will commence at 9.45 with registration and tea & coffee from 9.15 and it will finish at 16.30

Bulletin Board

OPDU's Recent Claims Experience

In recent months we have taken a number of notifications arising out of a wide range of circumstances. We set out some examples of these below which we hope you will find useful when considering internal risk management strategies.

Delays or inaccuracies in transfer values

Several months before her retirement, a scheme member requested a quotation of the benefits she would receive. Upon retirement, the scheme member was informed that the quotation had been inaccurate, and that the actual value of her benefits was over £100,000 less than she had been previously told. Subject to the scheme member being able to establish that she relied on the incorrect quotation to her detriment, she is likely to be able to recover this amount from the Trustees.

In another case, a member transferred her benefits between schemes. Having recently decided to take early retirement, she has been informed that due to a 12 month delay in the transfer of her benefits, a reduction will be applied to the transferred-in service. The error appears to lie with the transferee scheme and the Trustees and/or their administrator are likely to be liable to the former scheme member for the difference between the benefits that she will receive, and the benefits that she would have received were it not for the delay.

Investment losses

Simple administrative errors can also lead to the scheme suffering substantial investment losses. In one recent notification, a bulk transfer of over £1 million was inadvertently transferred from the wrong scheme causing significant investment losses. The error was picked up a number of months later during a data reconciliation exercise. Had the error not been spotted, the loss could have been far more significant. This illustrates the importance of regular data checks, especially since most transfers are made electronically.

Claims by third parties

The Trustees' relationship with third party advisers needs to be carefully monitored. We have been notified of one claim against Trustees by their former actuaries for unpaid fees and another by investment fund managers. In respect of the latter, the Trustees had not noticed that the scheme was continuing to receive the benefit of a discount on management fees long after the expiry of the agreed discount period. Whilst this cannot properly be considered to be a loss (as the scheme was never entitled to have the benefit of the discount), depending on the type of scheme, such an error has the potential to cause the Trustees unanticipated cash flow difficulties and/or additional administration costs rectifying the position. If the error was disputed, the Trustees might also find themselves engaged in protracted correspondence with the third party adviser.

Interpretation of the Trust Deed

Problems continue to arise out of problems with the wording of Trust Deeds.

These difficulties often do not come to light for many years. In one notification, two consecutive Trust Deeds were inconsistent, the latter Deed not reflecting the intention of the Trustees with regard to the benefits that members should receive. Whilst rectification is always an option, Trustees risk complaints or claims from members who stand to lose out by the wording of the Deed being amended retrospectively. In addition to ensuring that clear instructions are given to experienced legal advisers, these notifications underline the importance of reviewing scheme documentation at regular intervals.

Another notification that we have been involved with concerns the interpretation of an agreement between a trade union and the sponsoring employer as to the treatment of overtime hours for pension purposes. A dispute has arisen causing proceedings to be issued against the sponsoring employer. Regardless of the outcome of those proceedings, defence costs will inevitably be incurred by the sponsoring employer. These will be met by the OPDU Elite policy.

Early retirement requests

Complaints to the Pensions Ombudsman arising out of the Trustees' refusal to grant an early retirement request (often on the basis of ill health) continue to feature in many of the notifications we receive. Such refusals frequently give rise to complaints by Members that the Trustees have exercised their discretion improperly. As we have previously advised, Trustees should not underestimate how time consuming and expensive such complaints can be, regardless of the merits.

We urge Trustees to consider carefully whether the insurance cover they have is suitable for their requirements, being particularly mindful of the legal/actuarial costs that can be incurred even in circumstances where there is no actual claim against them.

Some Key Issues for Trustees

This is the second bulletin board of 2011 and these are just a number of issues currently testing trustees.

Bribery Act 2010

The Bribery Act 2010 became effective from 1 July 2011 and trustees should be considering what action they may now need to take. This could include the development of a hospitality policy and hospitality register if one does not already exist, together with further procedures and controls depending upon the trustee constitution and advice received.

Scheme Administration Standards

The Pensions Regulator has been highlighting the importance of administration in enabling good outcomes from pension saving. In a recent determination, the deputy Pensions Ombudsman upheld a complaint of undue delay in processing a transfer. In reaching a decision, the deputy Pensions Ombudsman stated that "it should take no longer than five working days to raise and issue a transfer value cheque". This acts as a timely reminder to review Scheme administration standards.

State Pension Age

Trustees are reminded that State Pension Age is still due to be equalised at age 65 from November 2018 and will then increase to age 66 from 2020.

Automatic Enrolment

If their Scheme is likely to be affected by automatic enrolment, trustees should be aware of the date from which this is likely to be applicable for the company. They should begin preparation to tackle issues associated with the implementation, administration and communication of these changes.

Finance Act 2011 (1) Scheme Pays

Following changes to the Annual Allowance, trustees are now engaging with their administrators to agree how, in practice, benefits will be abated so that an Annual Allowance charge can be paid by the Scheme.

Finance Act 2011 (2) Lifetime Allowance

With the Lifetime Allowance due to reduce from £1.8 million to £1.5 million from 6 April 2012, what further communication is required to Scheme members?

Finance Act 2011 (3) Annuity or Drawdown?

Now that members are no longer required to take benefits at age 75, trustees and companies may wish to consider whether to allow members in defined contribution schemes or sections, to take advantage of new drawdown and flexible drawdown pension provisions.

Finance Act 2011 (4) Rule Amendments

With the changes brought about by the Act, is there a need for rule amendments? These might be required, for example, to take advantage of maximum trivial lump sum commutations.

Solvency II

Solvency II is due to come into force in January 2013 and whilst there is no direct application to pensions, capital requirements for long term insurance products such as annuities and pension buy-outs are increasing, with a consequential impact on costs. Trustees and companies would be advised to keep an eye on developments and whether there are any more significant implications for pension schemes in the longer term.

Employer Debt

Trustees should acquaint themselves with the Department for Work and Pensions proposals for easements in the event of a company not wanting to make a debt payment (calculated on a buy out basis).

Pension Unlocking Schemes

We've seen these before. The Financial Services Authority (FSA) have warned about unlocking schemes designed to provide members with access to funds before they reach age 55, in this case by transferring funds to a corporate bond and then facilitating a loan to the member. Whilst trustees are usually not authorised or able to give individual financial advice, they may wish to provide a copy of the FSA's note if they become aware of this being considered by a member.

And that's not all...

There's plenty else going on including, longevity swaps, enhanced transfer value exercises, investment reviews against a background of volatile markets, considering the introduction of investment risk when calculating PPF levies, and the introduction of NEST Corporation to name just a few.

Claims

Some typical examples of the subject matter of claims in which OPDU has been involved:

- **Incorrect formulas used for calculating benefits**
- **Interpretation of Trust Deeds**
- **Overpayment of Benefits**
- **Misapplication of Scheme Rules**
- **Seeking Court Directions**
- **Early retirement & ill-health disputes**
- **Rectification proceedings**
- **Accounting irregularities**
- **DC choices of investment funds**
- **Pension Sharing Orders**
- **General administration errors**
- **TUPE issues**
- **Misrepresentations by trustees**
- **Transfer Values**
- **Incorrect quotations**
- **Discrepancies between scheme documentation and administration practice**
- **Delays in the transfer and payment of benefit assets**
- **PPF levy issues**

The issues have involved individual claim sums ranging up to £20m.

Bulletin Board

New Appointments

OPDU's unique structure includes the Advisory Council and its function is to ensure that the services and insurance provided continue to meet the changing need of insured schemes. We are delighted to announce that Dennis Buckley, Chairman of SAUL Trustee Company, has recently been elected to the Advisory Council.

The Advisory Council is as follows:

OPDU Advisory Council

Peter Murray
Chairman

Yally Avrahampour
Consultant

Steve Balmont
The Law Debenture Corporation plc

Dr Dennis Buckley
SAUL Trustee Company

Phil Casson
AstraZeneca UK Limited

Dermot Courtier
Kingfisher plc

Frank Curtiss
Railpen Investments

Robin Ellison
Pinsent Masons LLP

Robert Kearley
BAE SYSTEMS plc

Andrew Morris-Richardson
Abacus Holdings Ltd

Richard Thornton
Milk Pension Fund Trustees

Dan Schaffer

We are also very pleased to announce that Dan Schaffer has joined **OPDU**'s Advisory Panel.

Dan joined the Herbert Smith pensions group as a partner in March 2010, having previously been a partner in another leading City firm since 1998. His practice covers all aspects of occupational pensions law, with particular focus on strategic advisory and transactional work. He has also has a strong pensions disputes practice, having been involved in several of the most important cases in recent times. Dan designed the litigation costs aspect of the **OPDU** trustee insurance policy for the Railways Pension Trustee Company Limited.

Dan is recognised as one of the City's leading pensions specialists. He has chaired the Association of Pension Lawyers' International Committee and is currently a member of the Association's Legislative and Parliamentary Committee.

Dan's experience includes advising:

- TPG on the pension implications of its acquisition of Ashland's global distribution business
- Railways Pension Trustee Company on the management of the 100 section, £20 billion industry-wide scheme, including complex issues arising from the administration of railways maintenance contractor Jarvis
- Foster Wheeler Energy in their landmark 2009 Court of Appeal case, and subsequently on benefit redesign issues
- E.ON on pensions aspects of electricity pria range of issues, including scheme sectionalisation
- The Law Society on variouscontentious and non-contentious issues

The Advisory Panel is as follows:

OPDU Advisory Panel

Mark Blyth
Linklaters LLP

Lesley Browning
Norton Rose LLP

Philipa Connaughton
Reynolds Porter Chamberlain LLP

Mark Howard
Barlow Lyde & Gilbert LLP

David Lane
Lane Clark & Peacock LLP

Nigel Moore
CMS Cameron McKenna LLP

Giles Orton
Eversheds LLP

Ian Pittaway
Sackers & Partners LLP

David Pollard
Freshfields Bruckhaus Deringer LLP

Daniel Schaffer
Herbert Smith LLP

Peter Shave
Wragge & Co

Iain Talman
Biggart Baillie LLP

Peter Thompson
Consultant

Keith Wallace
Reed Smith LLP

Robert West
Baker & McKenzie LLP

News from The Pensions Archive

Progress continues to be made at the Pensions Archive with the cataloguing of the various collections received.

In May, Katy Johnson took up the role as Archivist to The Pensions Archive Trust. She is employed by the City of London: London Metropolitan Archives (LMA) but the Trust funds her position with donations and sponsorship from companies and firms within the pensions industry. The Trust is always pleased to receive both corporate and individual donations.

Katy studied History at the University of Manchester between 2004 and 2007 and graduated with a first class honours degree. She went on to work as an Archives Assistant at the Borthwick Institute for Historical Research, at the University of York. The experience gained in this role enabled her to obtain a place on the University of Liverpool's Masters course on archival administration, from which she graduated in December 2009. The course provided training in archival theory and practice, from appraising and accessioning new collections, cataloguing collections to international standards, preservation methods, and facilitating access to the collections. She also completed a dissertation looking at how online learning resources have been used by archives.

Post-qualification, she returned to the Borthwick to work on a cataloguing project, centred on a collection of papers from a Quaker family in York, the Tukes. These papers were of particular significance because of the Tukes' involvement with the reform of mental health treatment and other philanthropic work in the late eighteenth and early nineteenth centuries, and their position within the Society of Friends and ownership of a coffee, tea and cocoa business in York. On taking up her new position Katy said: "I am looking forward to working with The Pensions Archive Trust to preserve the history of occupational pensions and encourage people to access and learn from these collections."

When the Pensions Archive was established at the LMA one of the attractions was the extensive business archives (well over 1,000 collections in total) as well as many other collections relating to the history of London which could hold pension-related material.

In June the Trust, in conjunction with the LMA, launched a major project to unlock London's pension history and sought volunteers to work in conjunction with the Trust's Archivist to research these collections and assist in the compilation of a guide to pension material held in them.

This work is open to all, but is likely to be of particular interest to those who have retired from the pensions profession and have an interest in historic records and the development by employers of pension provision. The job specification can be found on the Trust's website under " Administration".

www.pensionsarchive.org

Malcolm Deering, who has been involved in the pensions industry for a number of years came forward as a volunteer on a part-time basis and has now started work with Katy Johnson identifying those business collections which have pensions material.

Anyone else interested in helping with this work should contact:

Katy Johnson, Archivist
The Pensions Archive Trust
City of London: London
Metropolitan Archives
40 Northampton Road
London EC1R 0HB
Tel: 020 7332 3879
e-mail:
Katy.Johnson@cityoflondon.gov.uk

Alan Herbert
Chairman
The Pensions Archive Trust
01438 869198
alanherbert@btconnect.com

The OPDU/ACE Annual Pension Risk Conference: "Putting Trustee Risk in Perspective"

3 March 2011 at CBI Centrepoint

"Another great event with excellent speakers and a fine audience"

In accordance with OPDU's aims of helping to raise standards of trusteeship and pension scheme management, we were pleased to jointly host the Conference with our underwriters, ACE European Group Limited, at no charge to delegates.

Trustees and those involved in running defined benefit and defined contribution pension schemes have to manage many potential risks. The Conference focused on key risks including: the separation of interests of the company from those of the trustee, increased complexity, legislation and regulation, senior company personnel no longer participating in schemes and the powers of the Courts, Ombudsman and Regulators.

The Conference was very well attended which reflected the calibre of speakers and the topical content of the programme. The feedback also confirmed that the panel discussions, which were factored in throughout the day, worked particularly well and gave ample opportunity for questions. An online version of the Delegate Pack provided on the day, including speaker's presentations, is available for viewing and can also be downloaded from the website: www.opdu.com

"I thought the conference was extremely enjoyable with some excellent speakers."











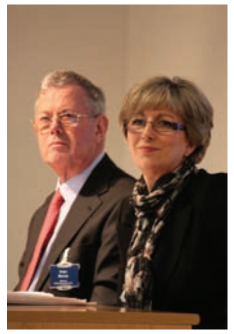









"Just a brief note to thank you for a first class conference yesterday. It was well worth the trip from Lancashire. The speakers, the venue, the organisation and the participation were all excellent."



"Another very successful conference with very good topics and speakers all day. Well done."




Trustee Risk:
A Lawyers' Perspective

Robert West, *Head of Pensions, Baker & McKenzie LLP*

"A trust is an office necessary in the concerns between man and man…. and, if faithfully discharged, attended with no small degree of trouble and anxiety" (Knight, the Earl of Plymouth (1747)).

I suspect that a wry smile will pass across the lips of many pension fund trustees who read these words. Trusteeship is an onerous task but, as they say, someone has to do it. So, by acting as a trustee, you are doing the right thing. But why should you run an unreasonable risk for doing it? And even if you are not liable personally for potential losses to the scheme, depending on how those losses arise, what risks does the scheme itself run as a result of your actions (or inactions)?

It is a matter of trite law, which most trustees will encounter on basic trustee training courses, that trustees are bound to use "such care and diligence in the management of the trust property as men of ordinary prudence and vigilance would use in the management of their own affairs". But, is this really a true representation of the position now? The short answer is a qualified "no" - expectations of trustees have changed - but the position in practice is much more complex.

What follows are the views of a pension lawyer of many years' experience, who has seen some fairly substantial changes in the legal climate during the course of his career. It demonstrates why trustees have every reason to feel that they and the schemes that they govern have some very material legal exposures which need to be addressed.

As a pension lawyer, I am much more conscious now of claims being made against pension schemes. They are conducted through the courts or the Pensions Ombudsman. They may, for example, take the form of applications for directions, claims for rectification or claims arising from negligence or maladministration.

Trustees must be conscious of the potential for civil or criminal penalties being imposed by the Pensions Regulator under legislation.

Trustees must also be aware of the potential for personal liability (which will not necessarily cease upon retirement as a trustee). They must manage appropriately their almost inevitable conflicts of interest. They may be faced with the potential cost of defending claims against the scheme, whether successfully or unsuccessfully. Furthermore, the scheme itself may be liable to meet claims even if (as is usually the case) the individual trustees are not themselves personally liable.

A question needs to be asked. Why is it that an increasing number of contentious issues appears to be arising in connection with pension schemes? Is it, for example, that we live in a claims culture or simply a more professional culture in which higher standards are expected? In general, I would say that both elements are involved, together with the increasing complexity of the issues with which trustees have to contend.

Some of the major current legal issues are indeed contentious and apply to many pension schemes. In my own practice, I see evidence of many of the substantial issues which have come before the courts in recent years, notably:

- Defective attempts to equalise benefits for sex discrimination purposes in the aftermath of *Barber* (1990): *Smith v Avdel* (1994) highlighted the problems of making retrospective amendments in the sphere of discrimination and *Foster Wheeler* (2009) has illustrated the difficulty of administering schemes in the light of changes made during the so-called *Barber* window in the early part of the 1990s.
- Defective conversions from defined benefit to defined contribution: notably the 2010 case of *German v HR Trustees* (the IMG case) in which historical restrictions on the scope of the power of amendment had been overlooked.
- Defective attempts to amend scheme rules: notably the need to use specified methods, such as a deed, as in the case of *BesTrustees v Stuart* (2001), and the need to meet the requirement for actuarial certification, as specified in the power of amendment considered in *Walker Morris* (2009).

Particular exposures also arise in the context of investment. As noted below, it is not possible for a scheme's rules to excuse a trustee from personal liability in respect of the discharge of his investment duties. At the same time, investment issues for pension schemes have become much more complex and diverse. The available asset classes have become considerably extended, investment strategies have developed in complexity and trustees may need to take some quite intricate decisions in relation to matters such as hedges, swaps and buy-ins.

The trustees may also be subject to individual member complaints. Many of them arise as a result of inaccurate benefit statements or inaccurate information provided to members. On occasion, this may lead to a benefit having to be provided when the rules themselves do not require it (*Catchpole v Alitalia* (2010)). In particular, in the context of a defined contribution scheme, there is "nowhere to hide". Inaccuracies will not necessarily all "come out in the wash" in the way that they might do by being hidden in the funding of a defined benefit scheme. Members see quite readily the consequence of delays in crediting contributions or in implementing switches in investments. Furthermore, an inappropriate range of investment choices may itself give rise to potential liability. It is of course relatively straightforward for a member to bring such a claim before the Pensions Ombudsman.

The problem for trustees, in many cases, is where the goalposts appear to have moved after the event. On occasion, the decisions of the courts have overturned established industry practice. As a result, practice in, say, the 1990s is now viewed with 20:20 (or 2011) vision - hindsight being, of course, a wonderful thing.

This problem is exemplified by the cases and changes in practice in relation to the amendment of pension schemes. Many years ago, it was the conventional practice to establish pension schemes by way of an interim deed. This procedure would enable the detail to be completed later, in the form of a definitive trust deed and rules. This procedure, in itself, has not been challenged. However, it was part of an overall practice of announcing benefit changes to members and then sweeping up those changes in the next edition of the rules, often some time after the change had become effective. The problem with this approach, however, is that a combination of new legislation (notably Section 67 Pensions Act 1995) and court determinations has cast severe doubt on aspects of that practice. Clearly, Section 67 raises difficulties in changing accrued benefits. *BesTrustees*, noted above, cast doubt on retrospective amendments, even if they have been the subject of prior announcements to members. This issue arises in particular in the context of retrospective attempts to equalise benefits and is causing many schemes serious concern.

The problem is not simply that the law either changes or appears to change. Over a period of time, practitioners (particularly the younger ones) begin to wonder how industry practice could ever have been the way it was. I would not seek to defend a practice merely because it was an accepted convention. However, perceived changes in the law – even those which may be intended to promote certainty – are apt instead to create uncertainty and concern about potential liabilities.

Of course, many of these industry practices have long since been eliminated. Does this mean that potential claims may be time-barred for limitation purposes? In some cases, the answer is "yes". However, in the context of pension schemes, limitation periods of six years are not necessarily the norm – in some cases the limitation period may be 12 or even 15 years. Furthermore, the clock may not start running until the facts upon which a claim may be based have been identified or, for example, from the date of a member's retirement (as in the case of *Barclays Bank v Kapur* (1991)). Indeed, the Pensions Ombudsman is not subject to such considerations. In general, his jurisdiction is limited to claims arising in the last three years, but there is no bar on the Ombudsman taking a claim relating to a much earlier period (as has indeed been the case in several instances). Finally, if all else fails, the wily litigator may attempt to identify a subsequent failure to remedy a deficiency, which re-starts the clock from the date of that subsequent failure. So it may be very difficult to draw a firm line under a contentious issue purely on limitation grounds.

From a personal perspective, trustees will naturally seek to rely on exclusion of liability provisions and indemnities. In most cases, a well drafted exclusion provision will be effective. However, there are some notable limits. Section 33 Pensions Act 1995 specifically excludes provisions which purport to excuse trustees from liability in respect of the negligent discharge of their investment duties. Cases in the area of private trusts have established, in some circumstances, that a trustee may not be excused from liability if he is "reckless" (*Armitage v Nurse* (1997)) or, perhaps, if he is "grossly negligent" (the Scottish case of *Knox v Mackinnon* (1888)). Furthermore, the trustee cannot reimburse himself from the fund if the Pensions Regulator imposes a penalty on him. The court itself may excuse a trustee from liability under its powers under Section 61 Trustee Act 1925, but only if the trustee has acted honestly and reasonably and should fairly be excused from liability. Of course, most scheme rules also provide indemnification from the employer, but this is of course dependent upon there being a solvent employer available to do this. Finally, even if the trustee is not personally liable, this will not of course necessarily save the scheme from suffering a loss.

These concerns tend to be amplified when a scheme is in decline. Trustees may feel isolated or divorced from the employer, which may well see its closed defined benefit pension scheme as yesterday's problem. So trustees may find relatively little support – or even continuing defined benefit knowledge – within the employer, particularly in the case of smaller or medium sized companies.

It is, of course, easy to say that these problems generally arise only if trustees do indeed act negligently. They need to take advice. They need to satisfy the requirements for trustee knowledge and understanding – and much support is available through trustee training and from the Pensions Regulator. All of this helps considerably. However, it must be recognised that the role of the trustee is a demanding role. The expectations of trustees have increased and show no sign of abating. It is a little wonder that a prudent trustee will want to consider carefully whether, for example, additional insurance protections are needed.

Robert West
Head of the Pensions Department
Baker & McKenzie LLP
robert.west@bakermckenzie.com
www.bakermckenzie.com

Covenant:
Is Covenant a Risk?

Taylor Dewar, *Partner, Ernst & Young LLP*

In its most recent guidance on 'monitoring employer support', the Pension Regulator states that: "The covenant is the employer's legal obligation and its ability to fund the scheme, now and in the future. The strength of it depends upon the robustness of the legal agreements in place and the likelihood that the employer can meet them. As scheme sponsor the employer underwrites the risks to which the scheme is exposed, including underfunding, longevity, investment and inflation".

There are therefore significant risks associated with covenant which need to be considered by trustees. These include structural risk, trading risk, cash flow risk and management risk and can be present in steady state conditions, during and because of corporate transactions and as part of the valuation process.

A defined benefit pension is like a lifetime employment contract. The key risk is that the employer's lifetime turns out to be much shorter than the lifetime of its pension scheme members. The Pension Protection Fund mitigates some of this risk, but is not necessarily a complete safety net and in any case should not be treated as such by trustees. Good governance requires trustees to assess and understand the risk, keep themselves informed of changes and seek out ways to militate against the risk.

A further risk that trustees need to be cognisant of is whether they have the right advisors for the situation they find themselves in. Situations have occurred in the past where sub optimal deals appear to have been done partly due to the quality of advisers used and as such trustees need to understand and be aware of the skills and services available to them as they seek to manage the risks they face.

Covenant risk in a steady state

Steady state can be one of the riskiest places to be as things can creep up on you! For example, market changes or a gradual reduction in employer health eroding cash and asset cover.

Businesses as well as people have a lifecycle. With businesses the lifecycle is not as predictable as with humans but in general it does follow a pattern: seed, start-up, growth, established, maturity and exit. The recent demise of Habitat provides a good example of the end of the life cycle for a business that fell into decline following market changes.

The covenant review should identify the employer's position in its life cycle and covenant monitoring should be used to assess changes.

As there is always a risk that the covenant may change irrespective of valuation dates or specific transactions occurring, the covenant should be monitored alongside the regular monitoring of the scheme's fund performance.

Trustees should use the information gained to continually assess whether past decisions, based on previous assessments of the ability of the employer to underwrite investment, inflation, longevity and other risks remain appropriate. Measures that tackle this risk include:

- Agreeing information sharing protocols with the employer
- Receiving regular business updates from the employer
- Conducting a business 'health check' at least once a year
- Instigating a process of dynamic monitoring; and
- Conducting and regularly reviewing a trend analysis to gain an understanding of the direction in which the strength of the employer is moving.

Covenant risk associated with transactions

Corporate transactions that lead to corporate change represent real risk to the covenant. However, from experience, one of the biggest risks associated with corporate transactions is that the trustees find out that the transaction has occurred after the event, when it is too late to take much meaningful action!

Often it is perceived that other stakeholders, such as the banks and shareholders, have greater leverage and are therefore treated with priority over the pension scheme. When the trustees are eventually advised often the details of the deal have already been negotiated by the other parties. Frequently trustees then find themselves in a position where they are asked to review and approve a transaction without full disclosure and subject to impossible deadlines whilst being advised that they risk damaging the business opportunity if they fail to comply! Not an easy situation to deal with and one which creates its own set of risks!

So as well as being in a position to properly assess any actual covenant risks associated with the transaction, trustees may wish to consider whether they have appropriate procedures in place to respond in the event of a transaction occurring. For example, by agreeing information protocols with management, identifying members of a transaction subcommittee, discussing appropriate procedures with advisors and considering possible conflict issues in advance.

Specific risks associated with transactions often involve:

- Structural change which lead to the scheme's subordination and put the scheme in a worse position in the event of corporate failure
- Increased corporate debt, which may be subject to new security arrangements, and results in a riskier covenant
- A change of control, maybe to an overseas parent, resulting in a reduction in influence for the Scheme and a potential move ment of funds or assets abroad; and/or
- Sale or movement of trading assets from participating employers to other Group entities and the creation of intercompany debt which reduces the scheme's security.

The tax related structuring of transactions also often fails to take into account pension risk and can lead to arrangements which are detrimental to the scheme.

In corporate transactions, experience shows that usually a solution can be found that protects the scheme and enables the company to proceed. But this inevitably requires negotiation and a full consideration of the facts.

Trustees therefore need to be prepared to act early, act quickly, use their advisors to the maximum and, if necessary, be prepared to say no!

Covenant risk associated with valuations

The covenant risks associated with valuations mainly arise due to:

- A lack of proper timetabling
- Information constraints; and/or
- Poor communication.

These risks can be guarded against by the careful programming of covenant work.

If possible trustees should agree a timetable for covenant review with employers that ties in with the employers own reporting timetable. This helps to avoid duplication of effort and covenant reviews that are based on out of date information.

Covenant considerations should not be left to the last minute, but coordinated with the actuarial review, ensuring that trustee needs are understood and addressed.

Advisors should also be asked to benchmark and contextualise their review of the covenant and to fully consider and address affordability issues alongside the covenant review. Often the covenant risk in valuations can be encapsulated by the debate surrounding covenant strength and affordability of contributions. Advisors need to be managed carefully in this regard and made to link their conclusions between these two areas.

Advisors should also be challenged robustly on their risk mitigation ideas, whether it be the provision of contingent assets, ratcheting funding plans or the taking of security to name a few. Inevitably there are pros and cons associated with each of these ideas and trustees need to ensure that they do not get presented with a shopping list to give to the employer. Blanket requests are inevitably met with challenge, however focused reasoned requests are going to find more traction and perhaps lead to a better overall solution.

Using advisors

Trustees may decide that they wish to engage professional advisors to help them assess and monitor covenant risk.

The experience of engaging and working with advisors and the success of otherwise of the process often hinges on the upfront communication and planning of the selection process and ensuring that everything agreed is encapsulated in a appropriate engagement agreement.

Typical features of such agreements and questions to ask include:

- The identity of the client: is it the sponsor or the trustees?
- The extent of services that are to be performed: will a covenant strength conclusion be reached together with advice on affordability and options for improving security or will it be something less?
- The expected deliverables: will the advice be provided orally, in written form or a combination of the two? What will be available to share with the Pensions Regulator if needed?
- The cost: what does it cover? Will it be fixed or variable? What happens with overruns?
- The team that will deliver the services: are they experts in what they do?; and
- Liability caps / indemnities: are these appropriate to the situation?

By addressing the above points and questions trustees should be better placed at the end of the engagement process.

Other upfront considerations include:

- Addressing real or perceived conflicts of interest;
- Agreeing confidentiality agreements;
- Agreeing ownership of reports and deliverables;
- Inclusion of trustee training; and
- Feedback and quality reviews.

The routine consideration and documentation of the above matters as part of the advisor engagement and instruction process should result in a process that delivers to expectation for all parties and ensures that advisors are used to their full potential.

As a dynamic and ever changing facet of the scheme health, dealing with the covenant is another challenge trustees face and need to proactively tackle. The most informed trustees have policies, procedures and protocols in place for doing this and I would urge all trustees to think about how well they do this.

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Covenant:
Covenant Assessment

Clive Gilchrist, *Deputy Chairman, BESTrustees plc*

"Covenant assessment is new, at least in the formal way now required and a new industry has grown up to assist trustees in the process. Do trustees need them? Or can trustees do it alone? If trustees do need assistance, what type of advice do they need?"

These are some of the issues facing trustees when trying to evaluate the covenant of their sponsoring employer.

"It is essential to form an objective assessment of the employer's financial position and prospects as well as his willingness to continue to fund the scheme's benefits." states the Pension Regulator's Code of Practice issued in 2006. But a lot has changed in the past five years; schemes that were then almost fully funded might now have significant deficits. Reduced asset values and lower discount rates as a result of the financial crisis coupled with improved longevity have conspired to reduce funding levels across the board.

If a scheme holds enough assets to meet its liabilities then covenant assessment is not important. To the extent that there is a shortfall, members can only expect to receive their full entitlement with the backing of a sound employer.

The theory is easy, though in practice there are many problems. Analysing historic financial data can build a picture of the current strength of the employer; a trustee board with the right skill set might even be able to do it themselves, though unless the answer is obvious or the employer structure simple they would generally be better off taking proper professional advice.

The key word is "objective" – one dictionary definition is "a test consisting of factual questions unambiguously scored". But "prospects" are not factual, they are subjective, almost by definition. Business plans and budgets can be helpful, as can stockbrokers views in respect of quoted employers. But they tend to be fairly short term in nature, not much help to a trustee with long term liabilities facing a recovery plan of ten years or more, and certainly not objective, as defined. If prospects are difficult to quantify, the employer's willingness to pay is even more subjective - the only evidence is that they have paid in the past. What might happen in the future as managements change, corporate structures change and schemes are viewed as legacies is nothing short of speculation. Willingness can disappear when it is most needed, which is perhaps why the latest guidance from the Regulator concentrates on ability.

In regulatory guidance issued in December 2010 tPR stated "Covenant should be assessed objectively. The ability of employers or guarantors to meet their obligations should be viewed in the context of the scheme's exposure to risk and volatility – for example from investment returns and demographic change,"

Again, objectivity is the key word, but this statement goes further and suggests that risk should be viewed holistically. Covenant is a risk, but so are investments, so are changes in mortality. Whilst undoubtedly true, this doesn't help in evaluating the employer's covenant.

In November 2010 guidance from tPR stated that "trustees should bear in mind the cost of covenant monitoring and any proposed action relative to the size of the scheme and the employer and to the potential benefit of the exercise." A useful appendix to the November guidance gives a comprehensive checklist of considerations for drawing up a brief.

This is more helpful as it suggests that a proportionate approach is required.

There is no point in spending a fortune on advice if the scheme's deficit is tiny or if the employer can't pay.

As with any professional advice, covenant assessment can be expensive, careful thought should be given to the mandate. Trustees should think about what is needed; more precisely formulated questions will result in better quality output and better value for money.

And help is at hand; an array of providers are willing to assist; covenant advisers come in all shapes and sizes.

Costs are clearly an issue, particularly for smaller schemes. Trustees should have realistic expectations of the output, and time spent in properly formulating the mandate will be well rewarded. If the requirement is for a simple one-off report, then a fixed price could well be negotiated. But if the report may lead to further stages of analysis or to the adviser assisting in negotiations, then the pricing for this should be agreed at the outset. The cheapest provider for phase one may not be the cheapest or the best if the requirements change. Proportionality and value for money are the keywords; the better the appointment can be specified, the more satisfactory will be the outcome.

The presumption must always be that external advice is required, but there are certainly instances when trustees may reasonably decide not to do so, if they have the ability to reach an objective view on their own.

Three real examples of when trustee boards that I sit on have not taken external advice are when the covenant is so bad that external advisers can add nothing to the debate, when the covenant sits within a large multi-national and the deficit is tiny within the context, and when the employer is based overseas and trades in the UK as a branch not a subsidiary.

In the first instance we felt it pointless to throw good money after bad. We agreed with the company that we would try to minimise advisers fees, indirectly their cost, in exchange for them improving their contributions into the scheme. We explained to tPR that external advice could only confirm what everyone knew, that the company had no assets and little earnings; spending money to confirm that would add nothing, but would further reduce what little was available to support the scheme.

The second example was the opposite. Although in deficit the scheme sat within a 'self-contained unit' of a large multinational. UK saleable assets were a multiple of the deficit and we reached agreement with the company that UK assets (trading entities) would not be sold without prior notification and discussion. We could have afforded to take advice, but after careful consideration decided that we didn't need to. We were able to reach an objective conclusion on our own.

In the final example the employer trades in the UK as a branch and the overseas parent provides the covenant. We regularly reviewed the (overseas) accounts and checked public announcements on their website; we noted that covenant advisers were unlikely to have relevant experience in the sponsor's country and that D&B do not score sponsors from the country directly. The conclusion was that the trustees could see little merit in seeking external advice. It would add huge cost to no obvious advantage.

It should be noted that these are specific examples which demonstrate that external advice is not always the appropriate solution. Generally speaking, however, trustees will be unable to evaluate the covenant objectively without seeking proper external advice.

Covenant monitoring is not just a one-off exercise. Though it may start with a valuation or a corporate event, the Regulator expects an ongoing programme of covenant monitoring. When appointing an adviser trustees should make clear their intentions in this respect. Ongoing monitoring may require periodic input from the adviser; equally, the adviser may be able to assist in establishing a framework so that trustees are able to receive appropriate information from the employer and do it themselves. If considered beforehand this should be part of the adviser selection process.

A final point worth noting is the conflict between management and trustee objectives. There is an inherent conflict between the private equity model whereby investor returns are maximised by investing as little cash as possible as late as possible and the trustee desire for prudent funding. This doesn't sit easily with the traditional collaborative partnership between trustees and employer.

But this conflict manifests itself in other corporate structures as well. Cash contributions above budget may adversely affect senior management bonuses, though that should not stand in the way of a sensible recovery plan. Conversely, the introduction of contingent assets through a special purpose vehicle could advance tax relief – to the advantage of management.

Trustees should be aware of these conflicts and, as in all negotiations, try to assess the strengths and weaknesses of the other party and to use them to advantage.

The conclusions are that external advice is not always required, though trustees need a very good reason not to. When appointing advisers trustees should consider their objectives and frame the mandate accordingly, noting that willingness to pay is far harder to assess than ability. The better that trustees can specify the mandate, the more satisfactory will be the result.

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Understanding risk in a DC journey

Daniel Morris, *Senior investment consultant at Towers Watson*

The nature of defined contribution (DC) is that investment risks are borne solely by the member and any losses have to result in lower pensions, more working years or having to save more. The challenge for fiduciaries is how to quantify, set an appropriate level for and then communicate, the level of investment risk inherent in a strategy, enabling members to take appropriate action in response to poor outcomes. Many DC arrangements offer a lifecycle strategy in which investment risk is steadily reduced in the years running up to retirement.

Being a member or a fiduciary of a defined contribution ("DC") plan is challenging, especially in today's environment. The events of recent years, and ongoing market volatility, have made us all re-evaluate our perspective on risk relative to return. DC members need to better address investment risk while fiduciaries need to rethink their investment strategy and have a higher regard to the balance of targeting return and exposure to risk.

This article focuses on a number of questions:

- How can fiduciaries of DC schemes use their knowledge about members, especially in relation to tolerance to risk, to design the investment strategy for retirement?
- How can members, regardless of financial education, understand the risks that they face?
- How can members reach their target pension and manage the risks?

DC risk

An indication of a member's risk tolerance is given by the level of losses that they can withstand if they do not achieve their retirement target. This paper considers long- and short-term risk metrics so that members and fiduciaries understand the investment-related risks associated with their retirement plans. The short term risk measures are framed in terms of the level of the extra contributions or extra working years that are needed to receive the same pension the member had anticipated.

But it is not just about the amount of risk that a member fears, since the timing of that risk is also very important. For example, people close to their planned retirement date may find it harder to work for more years if the value of their investment falls substantially.

In contrast, people further from retirement have more scope to respond and recover from any negative investment event.

So, whilst the absolute level of risk is a consideration, so too is the point in the member's lifecycle at which the member is exposed to the risk. For example, consider a member five years from their anticipated retirement date who suffers a significant fall in the value of his DC fund. He may have to continue to work and save five years longer than he had planned in order to achieve his planned level of pension, doubling his remaining working life. In contrast, a member who suffers the a fall in fund value with the same expected retirement deferral implications, but who is currently 20 years from retirement, has more time to adjust his income expectations and/or retirement plans. We call the possible extent of this expected retirement deferral 'Retirement at Risk' (RaR) – and we shall come back to explore this risk measure later in this article.

This framework for assessing risk can be used by fiduciaries and sponsors to design an investment strategy for retirement, where member risk remains within their own tolerances throughout their lifetime.

Understanding members' pension objectives

This article outlines a framework for setting a default investment strategy (or glide-path) for members of DC pension schemes. The three key metrics to consider are the long term expected outcome, the range of expected outcomes and the short-term risks

Investment risk in a DC context can be defined as the likelihood of failing to meet retirement objectives. This could be caused by: the value of investments falling, interest rates falling making annuities more expensive, or high inflation expectations making inflation-proofing more costly. Members are likely to have retirement objectives which could be framed in many ways. For example, members may want to retire on a pension which is a particular fraction of their final salary. They may want to retire on a particular level of real income. The possibilities are endless, but simple objectives add clarity to planning and decision making. Amongst the objectives, there will be numerous constraints. These constraints will be complex but include earnings, essential commitments (for example, mortgages), tax, discretionary spending and the member's health. Members should consider these risks in their retirement planning. Members can improve their expected pension by contributing more money and taking more investment risk. However, taking more risk exposes members to scenarios where returns are poor requiring members to put more money into their pension plans or work more years or accept lower expected pensions.

Long-term projections

Current best practice and legislation ensures that members of DC schemes receive annual statements of their projected benefits. Most commonly, these are in the form of SMPI (Statutory Money Purchase Illustrations) that show a projected benefit on a range of assumptions. SMPI provide information to members on different assumptions, conveying the uncertainty surrounding long-term projections. However, the likelihood and consequences of the different assumptions not being borne out in practice are not considered. Long-term projections can be used to estimate an expected level of pension and a range of outcomes around retirement. In this article we consider a member, entering a DC scheme at age 25 and investing in line with a 5-year lifestyle plan. (Full assumptions are in the appendix.)

We simplify the presentation of results to two metrics:

Expected Replacement Ratio (RR):

The pension a member expects to receive expressed as a proportion of their final salary before retiring. For this member the expected replacement ratio net of other retirement income expectations (for example, state benefits) is about 30%. Considering replacement ratio reduces the impact of inflation from the final salary.

Pension at Risk at Retirement (PaRR):

There is a 1-in-20 chance that the replacement ratio at retirement will actually be less than its expected level by at least this amount. This provides members and fiduciaries with information on the extent of a potential reduction in the replacement ratio at retirement. For this member, the PaRR is about 21 percentage points – meaning there is a 1-in-20 chance that the replacement ratio could be 21 percentage points less than expected, providing a replacement ratio of 9% or less. The fiduciaries and sponsors of DC schemes will need to consider how the expected outcome and range of potential outcomes meet the needs of the different categories of member. However, it should be noted that long-term projections used in isolation can steer members and fiduciaries towards holding (or purchasing) high proportions of risky assets since the potential level and timing of volatility is not explicit. For a member aged 25, the term to retirement is in the order of 40 years. To rely on such long-term measures alone is therefore placing significant trust in earning high returns and ignores how members could respond to the incidence of investment loss during the run up to retirement. Considering only long-term projections can drive a bias to taking more risk but without a full understanding of the consequences. The actual growth rate of the assets, member salary and annuity prices are rarely in line with expectations so we need to also consider the impact of short-term fluctuations. Added to this, members may over-estimate their pensions because they are optimistic about their plans and the outlook for annuity prices.

Relevance of short-term risk measures

Addressing the short-term risks that members face should be incorporated into the framework for setting the investment strategy, thus reducing risk or simply considering it much more explicitly, enabling fiduciaries to design default investment strategies that limit the impact on member's planning and behaviour:

The anxious planner

- Poor returns lead to anxiety over the value of the DC fund and give rise to concern over the value of long-term saving versus other investment vehicles. There is a risk that members "lose faith" with their pension scheme and stop contributing.
- The member may experience poor asset returns. For example, losses in equity markets may be linked with a poor economic outlook. This may lead to less job security, less pay and a reduced ability to make good the shortfall. This further increases risk to members as these risks, dependent on their employment, may be correlated.

Short-term behaviour

- Members may respond to short term fluctuations in asset values and market outlooks. This could lead to members deviating from their long-term plan because they do not fully understand the risks that they are taking on to generate targeted returns. A possible implication of this is for members to sell equity holdings as they fall in value. The member is exposed to risk throughout their working life. For members a long way from retirement, retirement planning can be a distant thought. Understanding risk serves as an educational and communication tool to engage members – although to do this, risk needs to be expressed in a simple and intuitive fashion. Short-term risk measures increase in relevance as the term to retirement becomes shorter because the member has less time to correct poor asset performance. Purchasing assets (such as bonds or cash) to match the member's retirement needs becomes a more significant part of retirement planning.

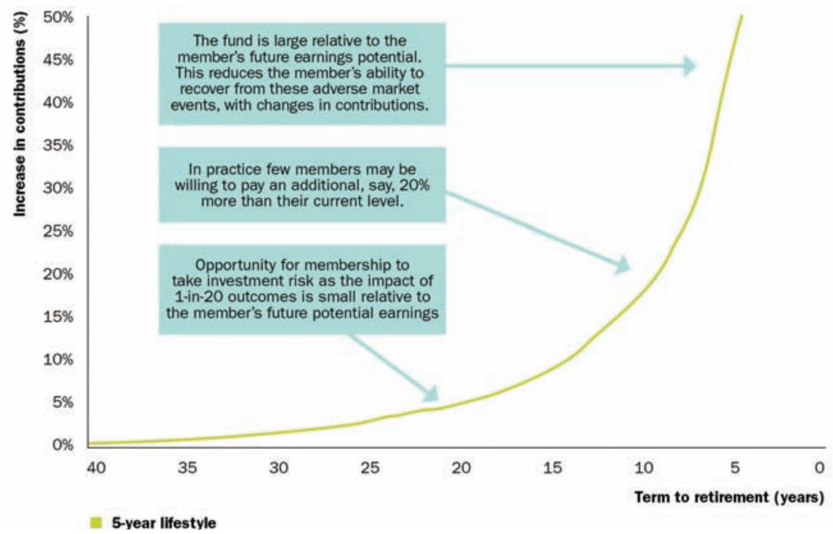
Introducing short-term risk measures

Having previously introduced the concept of a member's target outcome (replacement ratio and retirement age), short-term risk metrics should be expressed in terms of the actions required to continue to meet this target outcome. A member can influence the likelihood of meeting their objectives by adjusting their level of contributions, increasing or decreasing the investment risk they employ and altering their objectives (the level of expected pension or planned retirement age). We therefore introduce three short-term risk measures that a member is exposed to over their journey to retirement:

- Contributions at Risk
- Retirement at Risk
- Pension at Risk.

Figure 01. Contributions at Risk

Additional contributions required of the member for their remaining working life to recover from a 1-in-20 event over one year



Contributions at Risk

Contributions at Risk (CaR) is the minimum increase in the level of contributions required to recover from a 1-in-20 event over one year such that the expected pension at retirement is maintained.

Three conclusions can be drawn from this measure:

- For the period until the member is about 20 years from retirement, the level of CaR is below 5%. Losses are easily corrected with a modest increase in contributions. This supports members taking risk in their asset allocation for this period.

- For the period between 20 and 10 years to retirement, the CaR increases from 5% to 20%. This is a risk event that members would seek to avoid since the cost of correction is high. Members should be aware of the consequences of this risk and if the level is too high, consider alternative investment strategies that reduce the level of CaR at that time.

- For periods shorter than 10 years to retirement the CaR increases significantly to rates in excess of 20%. As the member's term to retirement reduces, the size of the assets relative to their salary (and potential future contributions) increases and the ability to make larger contributions diminishes. The number of members willing to increase their level of contributions by 20% may be small. This supports members reducing exposure to investment risk as they approach retirement.

Retirement at Risk

Retirement at Risk (RaR) is the minimum increase in a member's active working life required to recover from a 1-in-20 event over one year in order to maintain the same expected replacement ratio at the later retirement age. By retiring later a member's pension fund is expected to grow with more contributions and investment returns. As the member's term to retirement reduces they have less ability to correct the impact of adverse market events through their contributions (as seen previously) and instead may choose to defer their retirement in order to receive the same expected pension.

When the term to the planned retirement date is large the member may seek to correct deviations from the expected outcome with contributions or hope that improvements occur.

There are two conclusions from this measure:

- Towers Watson research shows that, typically, members do not expect to delay their planned retirement by more than four to five years. In this example, the level of risk is exceeded for the period from 20 years to retirement until around three years from retirement. Typical members should consider reducing their allocation to risky assets if they cannot tolerate the risk associated with the investment strategy.

- Whilst the absolute level of risk is a consideration, so too is when the member is exposed to the risk. For example, consider a member five years from their anticipated retirement date who is exposed to six years of RaR. There is a 1-in-20 chance that they could be required to work six years or longer than anticipated, more than doubling their working life. However, a member who is 10 years from retirement responding to the same level of RaR, has more flexibility to adjust their income expectations, retirement age or contribution. The member's ability to change their retirement age may be subject to employment constraints. Where members do not have the ability to retire later than planned, fiduciaries should seek to minimise this risk as the member approaches retirement, or communicate this risk so that members understand the investment risk they are exposed to.

Figure 02. Retirement at Risk
Number of years retirement deferral to recover from a 1-in-20 event over 1 year

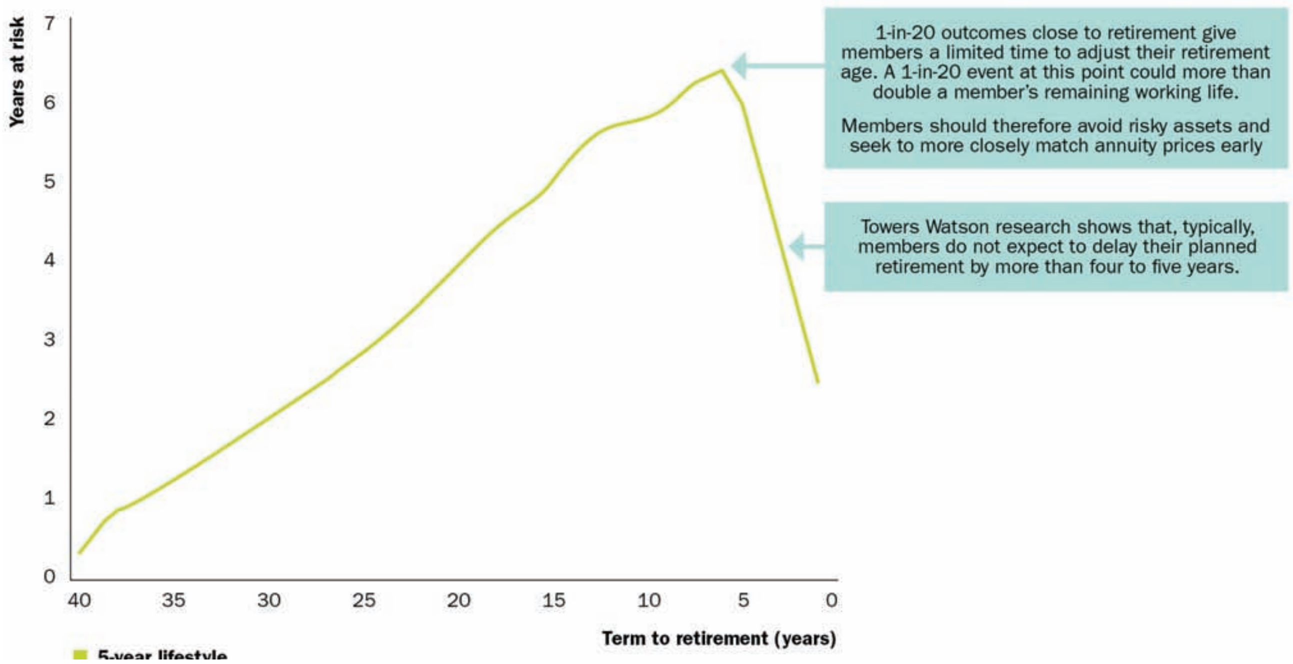
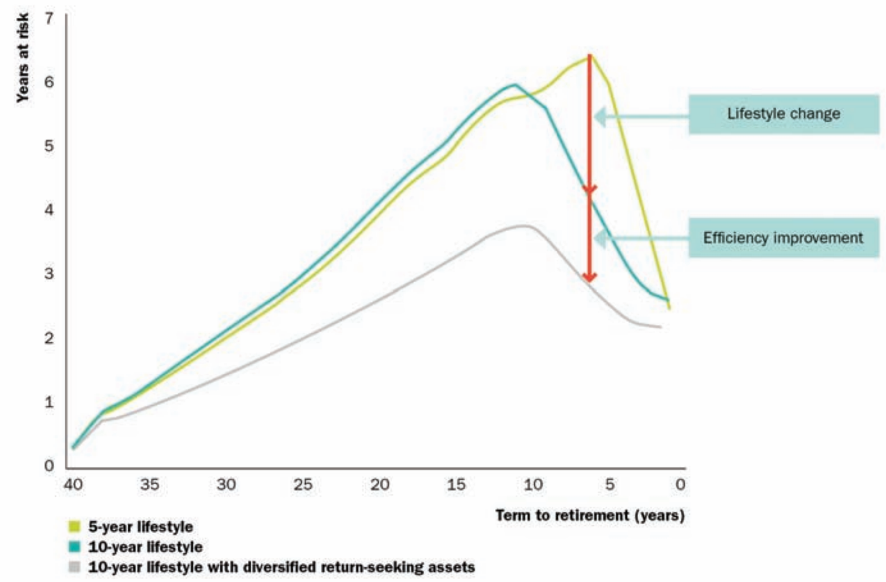


Figure 03. Pension at Risk
Number of years retirement deferral to recover from a 1-in-20 event over one year



Pension at Risk

The final factor that we consider is Pension at Risk (PaR). PaR is the minimum reduction in a member's expected replacement ratio as a consequence of a 1-in-20 event over one year. This measure is relevant where members are no longer in a position to meaningfully increase contributions or defer retirement. Their remaining option is to accept a lower pension and adjust their retirement plans accordingly.

A worked example that demonstrates the framework

We review how the member in this paper can reduce their exposure to risk by considering the number of years of RaR. The highest level of RaR occurs at around five years from retirement for the 5-year lifestyle strategy considered. A 1-in-20 or worse outcome close to retirement allows members only a limited time to adjust their retirement age. Reducing the RaR at this point gives members more certainty about their ability to retire with the pension they expect at their planned retirement date. The first step is to consider the impact of moving from a 5-year lifestyle strategy to, say, a 10-year lifestyle strategy. This reduces their expected replacement ratio from 30% to 27%. However, the RaR that the member is exposed to five years from retirement is reduced from six years to four years. Introducing diversification into the return-seeking assets of this lifestyle programme further reduces the RaR to around three years. This reduces the expected replacement ratio from 27% to 24%. It is important for fiduciaries and members to understand the underlying risks that members are exposed to. Some members of DC plans may be able to tolerate the exposure to investment risk implied by the initial strategy, however, other members may not and their strategy should be adjusted to levels of risk that they can tolerate. Members who cannot tolerate the higher risk, and consequently have a lower expected replacement ratio have a choice of increasing contributions to earn the higher expected replacement ratio of 30%, or to accept a worse expected outcome if they make no change to their contributions. To achieve this level of investment efficiency, an appropriate governance structure will need to be in place to monitor the performance of the portfolios versus the stated objective. Timely decisions with regards to changes in asset allocation and investment managers can then be made.

Conclusion

Members of DC plans should only take risk when they have the flexibility and tolerance to adapt their journey plan or objectives to recover from a poor outcome. Fiduciaries can help members to understand the risks inherent in their DC fund by providing easy-to-understand tangible information regarding the possible impact of bad events occurring during the journey to retirement. Measures that focus on both the short term and long term will enable members (and fiduciaries on a member's behalf through a default investment strategy) to create and maintain a strategy that better manages risk and expectations.

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Appendix

The modelling in this paper is based on a theoretical member who joins the DC scheme at the age of 25, with a retirement age of 65. They join the DC scheme with a starting salary of £20,000 per annum and earn increases of 1% per annum in excess of RPI. The contribution rate is 8% per annum. The asset allocation follows a five year glide-path design, starting at 100% equities and moving to index linked gilts. Inflation, yields and investment returns are based on the Towers Watson asset model.

Report 29 OPDU

Defined Benefit (DB) and Defined Contribution (DC)

Joined at the Hip

Chris Hitchen, *Chief Executive, Railpen*

Value and growth are joined at the hip, according to Warren Buffett. By this remark, we take the Sage of Omaha to mean that it is foolish to pursue growth so single-mindedly that we ignore price: Nor should we be deceived into buying stocks just because they appear cheap – they might offer not just low (or no) growth, but declining earnings which eventually make the prices we paid look expensive after all. GARP, or Growth at a Reasonable Price, attributed to Fidelity's Peter Lynch, is one system for steering a course between these investment equivalents of Scylla and Charybdis.

I believe that investment strategies for Defined Benefit (DB) and Defined Contribution (DC) pension schemes should also be joined at the hip. Whether DB or DC (or risk-sharing approaches in between), pensions have one primary purpose – to collect money from people whilst they are working and pay it back to them when they stop, hopefully with an investment return on top. Why would you do things very differently therefore in the two cases?

Young v Old

At a high level, one can say that this is what often happens. It is very common in DC plans for members to be defaulted into "lifecycle" strategies which enable them to take higher levels of investment risk when they are young and which dial down the risk as they approach retirement. If we look at DB plans in their historical context, we can discern a similar pattern: When they were "young", with few pensions in payment and affordable contributions for their sponsoring companies, they too accepted significant stock market exposure in pursuit of good long term returns. Now they are mostly "older", with maturing liabilities and lower or no capacity to deal with the consequences of market downturns, so they are naturally investing more in liability-matching assets such as bonds and swaps. Just like the mature end of a lifecycle fund as it prepares its DC members for annuitisation.

In practice though, there are often significant differences in execution. DC default funds often allocate 100% of the member's pot to quoted equities in the growth years, but it would be unusual for even an immature DB plan to do this. At the upper end of the age range, DB plans are probably slower to switch out of growth assets and into bonds and cash, despite increasing employer desires to buy out the liabilities. With yields on index-linked bonds and latterly conventional bonds nailed to the floor, it is sometimes hard to see that there is long-term value in executing a de-risking strategy. But it still makes perfect sense for an investor with a very low risk budget (such as a trustee who can no longer count on the sponsor's covenant), or one who can make better use of his or her risk budget elsewhere (such as a Finance Director with factories to build).

Wise heads such as Don Ezra, the Russell Investments doyen of investment consulting, have expressed the view that the provision of retirement income through a DC route is necessarily more expensive than a DB approach because the absence of risk pooling necessitates lower risk-taking and so likely lower long-term returns. That may be so, but we need not compound the error by allowing higher charges and poorer governance to persist in DC plans. Initiatives such as NAPF's Pensions Quality Mark are driving up standards by giving employers recognition for running plans with reasonable charges, clear accountability and a decent contribution rate.

Different schemes, different targets

I am a Trustee member of NEST though my day-job is to run the mainly DB arrangements for the UK's railways. Although there are many differences, I am fascinated by the things the schemes have in common. On investment strategy, both schemes have at their core an in-house diversified growth fund, attempting to beat inflation over the long term by investing in a varied range of return-seeking assets. It is true that NEST's outperformance target is lower than we have at rail, but this is not just the ineluctable power of Don's maxim, it is a rational response to market testing. The mainly lower to middle income people who will be the mainstay of NEST's membership are reluctant to accept investment losses. We know because we asked them. We can't guarantee there won't be investment losses, especially in these turbulent times, but we will try to limit them so that people have the confidence to keep saving. That's the most important determinant of their outcomes in retirement.

Going concerns

The Finance Director of a company with a large DB plan may not be so different from the average NEST member in that he or she has limited appetite for hits to the company balance sheet. Many of us have come to regret the way that successive accounting standards have reinforced marking-to-market as the method for recording pension scheme liabilities. It is important that in reporting on the progress of members' DC plan accounts, we don't repeat this mistake. Sure, tell the member what's in his or her account (if we have to!) but make sure it's contextualised by an unbiased projection of retirement income if the member keeps saving. Let's treat pension schemes as a going concern once more!

This is not to say that we should assume that future contributions can be relied upon, whether from employer or employee. There are around two hundred employers operating in the rail schemes, and we now employ an in-house covenant team of four highly experienced specialists to monitor them and negotiate on behalf of the Trustee where appropriate. Clearly the same approach can't be taken with individual members: NEST knows there will be gaps in contribution records and so concentrates on ensuring the arrangements are low maintenance, cheap and easy to come back to.

Joined at the hip

If you are joined at the hip to somebody, it may mean that you are about to attempt a three-legged race! Most of us have distant memories from school sports days of how hard it can be to make progress. UK pension funds find themselves in a not dissimilar situation, not just attached to one neighbour but to thousands of others. Oh, and the ground is very lumpy and steeply uphill. To make any progress, you need a clear strategy, lots of patience, resilience and a sense of humour. On your marks, get set, GO!

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Trusteeship in an Evolving Landscape

Bill Galvin, *Chief Executive, The Pensions Regulator*

The role of the pension scheme trustee has radically changed since the 1993 Pensions Act introduced a new regulatory environment for occupational pensions.

The creation of our predecessor OPRA, the minimum funding requirement, member-nominated trustees, and new record-keeping and information disclosure requirements, all helped to increase the security of members' benefits.

With the Myners report in 2001 and the Pensions Act 2004, we saw a new onus on schemes to ensure decisions were taken with specialist expertise, to approach defined benefit funding from a scheme specific perspective, and to ensure that at least one-third of trustees were member-nominated – as well as many other provisions. The Pensions Regulator's trustee toolkit has supported trustees in getting up to speed with these developments.

All of these changes have taken place against the backdrop of trust law, and all of them have been dependent on the continued hard work and dedication of over 100,000 trustees.

And throughout all these changes, we've seen the UK occupational pensions industry grow and evolve. There are now over 10 million pension scheme memberships, with 2 million individuals actively saving for retirement.

There are nearly 7,000 occupational DB schemes and more than 46,000 DC schemes, although only 600 of these DC schemes have over 1,000 members. We've recently spoken about the specific risks facing small schemes, and this is a big issue for us and the 38,000 DC schemes which have less than five members.

We released our scheme governance survey this summer and there was some encouraging reading for trustees. 96% of schemes believe their trustee boards are governing effectively overall, and awareness of the Regulator's record-keeping guidance has risen to 74% from 48% in 2009.

But there is clearly room for improvement in some areas, with just 40% of DC trustees believing their overall governance is very effective compared with 65% of DB trustees.

Looking to the future, increasing numbers of closed DB schemes, the durability of trustee bodies which are potentially dependent on constrained employers, and an increasing number of DC memberships are just some of the many issues which trustees will have to address.

Automatic enrolment will likely increase the number and scale of occupational DC schemes in the UK. Contribution levels, investment decisions and the management of decumulation all carry more risk to members in a DC scheme, and we've identified these and other areas as being key to good member outcomes in retirement.

We need to ensure that these schemes, if they are to become more common, have the right governance structures in place from the outset. DC schemes require many more individual transactions for each member, increasing the importance of good administration and record keeping. We expect trustees to focus on these areas.

There is clearly still a way to go as the landscape continues to shift and we face new challenges. These include the management of more and more closed DB schemes, the role of small schemes, the introduction of automatic enrolment from 2012, and the changing shape of the trust entity. We'll continue to provide information and support to trustees, with additional guidance and educational materials available later this year.

We don't underestimate the challenges posed by the seismic shifts in the industry landscape, and the increasing levels of skill, expertise and accountability required of trustees as a result. We're excited to be working with the trustee community to make sure the next stage in the evolution of UK pensions is a successful one.

Bill Galvin
Chief Executive
The Pensions Regulator

Pension Administration

Turning Wishes into Reality - A Tale with a Happy Ending

Sue Applegarth, *Managing Director, MNPA*

Pension Administration is often described as the Cinderella service of the pension industry. As for any fairy tale, the question is "How does Cinderella achieve her full potential and live happily ever after?" Indeed, moving with the times, how does she line up the potential for a successful sequel?

My aim, in good Disney tradition, is to look at how a great cast and an excellent director (your irrepressible administration team) can weave their magic and turn administration wishes into reality, both today and in the future.

Following tradition, we will start our tale with …

Once Upon a Time

…… there was an administrator who wanted to keep everyone happy. Her first job was to be clear about what wishes needed to come true and for whom. She also needed to know what gremlins might be lurking and how to deal with them.

The Wish List

She discovered that different customer groups have different wishes. She discovered that scheme members, the trustees, the pension manager, the sponsor, the Actuary, the auditor and potentially lots of others all wanted different things.

The Member

Members seemed to want to be paid the right benefit at the right time. They wanted to deal with people with the right attitude to service and who could communicate clearly with them at all times. They also expect to be treated as a valued customer. What this meant also varied between members and schemes but, as a minimum, members wanted to deal with an administrator who was easy to get hold of and understand, knowledgeable and empathetic and delivered what they promised in a friendly and helpful way.

More and more, members also wanted access to data 24/7 so they could look up what they wanted when they wanted, and even do certain transactions themselves, on-line.

The Trustee

Trustees wanted everything the members wanted, plus a lot more. They wanted the service to be compliant technically, legally and contractually. And they wanted this all proved to them! Enough information so they could see what had happened in the past and what was planned for the future, thereby satisfying their governance responsibilities.

Trustees also wanted low risk and to be confident any risks had been identified and appropriate controls implemented and managed effectively. Talk about a crystal ball!

The Employer/ Pension Manager

Pension Managers wanted the administrator to keep all the members and all the trustees smiling, all the time.

They also wanted support with planning the future. This required understanding the implications for administration when stuff changed (legislation, market requirements, IT, corporate strategy – and lots more) and the ability to do something about it. Examples seemed to be closing schemes to new entrants and future accrual, opening new DC arrangements, undertaking de-risking exercises such as enhanced transfer value exercises and pension increase exchanges. General data cleaning and management might also be part of a wider scheme journey plans leading perhaps to buy-ins, wind ups and ultimately full buy-outs of benefits.

A good working relationship was on their wish list too. The Pension Manager is the "filter" for trustees when it comes to day to day management and oversight of administration. As a result, they need to understand the big picture so that they can advise the Trustees and maybe even prevent potential problems becoming reality.

Cinderella (The Administrator)

Cinderella thought about all this and felt that she had a right to her own wish list too. She wanted to make their wishes come true but administration is a people business, and you need a motivated team to deliver. Recognition for a job well done was top of her wish list – even if Prince Charming did not deliver it personally.

Being business savvy, she also realised that she would need to budget properly so she had a sustainable and profitable enterprise – after all, the Fairy Godmother is a bit strapped these days.

Being a clever girl, she also wanted to know how her team were performing so she could prove to all those customer groups that she had delivered their wishes. Success criteria needed to be agreed with appropriate KPIs for each aspect of the service so performance could be measured and monitored, good performance rewarded and underperformance rectified.

What about Gremlins?

There are always gremlins. You just have to find 'em and get rid of 'em.

Data

Much has already been said around the data gremlins, who hide away in historical data or pop up unexpectedly on interfaces. The Pensions Regulator has set out its expectations for getting rid of these gremlins so most schemes should be putting in place strategies and plans for good record-keeping and data management. There are plenty of tools available in the market to highlight gaps and inconsistencies in common and conditional data.

Such exercises can be financially justified with real and valuable direct liability savings. For instance, one scheme found that undertaking a review of members over retirement age who were not claiming benefits, deferred members marked as "gone aways" and contingent spouses' data, resulted in a potential reduction in liabilities of £70m – which for a scheme with a £400m+ deficit is not to be sniffed at. There were also 700 families who had benefits they had not "claimed" paid to them because they were traced. So a great result and so many gremlins sent packing.

Calculations

Another key hiding place for gremlins to lurk is in calculations. Greater automation means less potential for error. But let's remember it is not just about the calculation being automated. It is about automating the "end to end" process, from request of calculation to production of letters and population of the records without administrators needing to "step in" at any stage. All such intervention increases the risk of gremlins emerging and upsetting the apple cart.

Processes

These need to be fit for purpose, be followed and have a good audit trail. Gremlins will try to over-engineer them, leading to a "tick-box" mindset for the administrator, lack of ownership and inefficient and ineffective service. A good process will recognise steps that add value or mitigate risk and leave little hiding room for gremlins.

People

Pension administration is complicated – particularly open DB administration – so occasionally people make mistakes. To reduce the chances of the "foul up fairy" visiting, you need to have people with the right experience. Technical training is as important as management and soft skills training.

Given the amount of change in the industry generally, the mix of skills needed for successful administration is changing and this needs to be recognised. Having the right balance of skills in a team is important so that some can concentrate on day to day member service and others deliver projects. Effective planning will allow the right resources to be built up – whether permanent, temporary, in-house, third party, or a mix of all, to successfully meet all those wishes.

Communication and Relationship Management

This is real gremlin territory. From a communication perspective, information overload can be as harmful as a communication black hole, whether that be with members, Pension Managers, trustees' or other advisors. Maintaining healthy, open and constructive relationships is therefore vital. Gag that gremlin!

Measuring What Matters

So, the challenge for Cinderella is to:

- reduce the chances of gremlins materialising which damage service and relationships, and
- maximise the chances of delivering the wish list for all parties.

Cinderella wanted Good Management Information to help her do both. After some thought, she came up with the following checklist.

Response Times

One measure was time. Were things getting done in the target response times? If not, why not? Was the failure down to Cinderella and her team or outside their control? What could be the mitigating actions?

Looking at work "in waiting" was one good way to make sure there were no "hidden" resourcing problems or member satisfaction issues building up because work was "in waiting" rather than being completed at the first opportunity.

Accuracy

Cinderella wanted to know not just whether the calculation was right, but whether the letters were correct, enclosures attached, etc. as nothing annoyed members more than getting half an answer when they expected a whole one.

Compliance

Measures were needed to make sure that everything had been done in accordance with legislation - whether pensions legislation, data protection or FSA regulations or whatever.

Member Satisfaction

Cinderella found that asking members to complete a simple questionnaire, issued whenever a substantive piece of work had been completed, produced a mine of useful information about members' views on timeliness, ease of access, clarity of advice and whether promises had been kept. This told her whether member wishes had, indeed, been met and was arguably more important than SLAs as a measure.

Other methods Cinderella considered were telephone monitoring and random shopper phone calls. What was important was consistency and that responses, where negative, were followed up so wishes could be met in the future.

Complaints

Cinderella spent some time looking at the number and root causes of complaints, classifying the failures by type, for example, failure to follow process, lack of knowledge and understanding, lack of care and attention. Analysis by category helped distinguish systemic failures from "human error" mistakes.

Compliments

Keeping a balanced view of member service was important and so Cinderella kept all the compliments as well as the complaints. Positive feedback to the administrators helped reinforce energy and motivation to deliver on those wishes.

Work Output

Member satisfaction is not the only important measure when assessing service quality - efficiency and effectiveness are vital too. Measuring work output – for example number of processes per administrator per day – is one good measure of efficiency, but should be looked at alongside levels of rework (work rejected in the checking process) and error rates. "Getting it right first time has to be the most efficient and least risky way to deliver the service" Cinderella thought. "Quick but wrong" does no-one any favours and was so costly in so many ways.

Key Risks

Understanding the type of risk and likelihood and impact of that risk materialising was important – Cinderella invested in a set of traffic lights (crystal balls being hard to come by) to help highlight "red" risks so they received appropriate management attention.

Resourcing

Monitoring turnover and managing vacancies is vital, as is planning for the future, to ensure the right skill sets, staffing levels and tools are in place to deliver those wishes.

Financials

Cinderella employed a bean-counter.

Collating all this Management Information alone does not turn your administration service wishes into reality: acting on the information does. So Cinderella put in place a good review process to improve poor performance and build on good performance.

The Magic Wand

It will come as no surprise to anyone in administration to know there is no magic wand that can be waived to deliver excellent administration. In summary, turning administration wishes into reality is about:

- Knowing your wish list – requirements of all customer groups, success measures and KPIs.
- Knowing where the gremlins hide – identifying, monitoring and managing risks.
- Having the spell book in place – the actions you will take to deliver your administration business plan and adapt to changing circum stances.
- Acting on good management information.

Happy Ending

It is possible to deliver a happy ending in administration. And doubtless, as we look ahead to the changing face of pensions – auto-enrolment, closed DB schemes, buy-in and buy-outs – "Pension Administration - The Sequel" will become a new blockbuster.

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Claims, Potential Claims & Protection:

Trusteeship and How to Survive It

Mark Grant, *Partner, CMS Cameron McKenna LLP*

The most important thing a trustee needs to understand is their powers. 'Knowledge is power' and knowledge of your powers is power. Without that knowledge a trustee's survival chances are severely reduced.

What powers does a trustee have?

Given the importance of the matter, you would think the powers of trustee of a particular pension scheme would be set out in one nice neat place. However, case law means that trustees often need to look at lots of different documents to understand the full scope of their powers and indeed the benefits that they are obliged to pay to members. For example, in a recent case involving the IMG Pension Plan, various changes were made to the scheme in 1992 that were in compliance with the scheme's amendment power contained in its most recent trust deed (from 1981) but the High Court held that the restrictions in the amendment power contained in the previous trust deed (from 1977) remained relevant, and some changes purported to be made in 1992 were therefore ineffective.

Also, where different scheme benefits have been communicated to and accepted by members, this can give rise to contractual terms that sometimes override what is in the scheme's rules and more or less generous benefits may arise as a result.

Therefore, trustees or, preferably, their advisers, need to be like Indiana Jones and excavate through lots of old deeds to know about those powers, and know what has been communicated to members to know what their benefits should be.

Trust law as well as pensions legislation expects trustees to know the terms of their trust, so ignorance is unlikely to be a good defence. Of course, that is just where the fun begins. Once you have collected the words that set out your powers, you need to work out what those words mean and how to exercise the powers in any situation facing you.

Trustees often inherit words prepared many moons ago that could have alternative meanings. For example, have a think about these beauties that the courts have grappled with. They are restrictions in amendment powers:

"reducing any benefit then provided by or under the trust deed for or in respect of any contributor or pensioner"
(Gas & Fuel Corporation of Victoria [1991])

"have the effect of… decreasing the pecuniary benefits secured to or in respect of such Members under the Scheme"
(Lloyds Bank [1996])

"have the effect of reducing the value of benefits secured by contributions already made"
(IMG [2009])

The first two were held to mean that no future service (or past service) related reductions to the current benefit structure could be made. The third one meant that continuing salary linkage had to be maintained for past service.

It was only an Australian case, but it was cited in the other two English court cases without criticism and it ties in with the respect the courts tend to show to any member-friendly protections in scheme amendment powers.

Exercising powers

Once you have worked out where the words are and what they appear to mean, you can't just exercise them however you want.

First of all, you can only exercise a power for the purpose that it was given. That sounds perfectly sensible but where does it say what the purpose is?

You also have to take into account all relevant factors and no irrelevant factors, but that of course means you have to form a view about what a court or the Pensions Ombudsman might consider to have been relevant or irrelevant from the trustee's perspective and it isn't always obvious.

Will our scheme's exoneration clause save us?

Many schemes have an exoneration clause that says a trustee can't be liable unless he acts dishonestly. So can trustees take all of this theoretical risk with a pinch of salt?

Trustees can certainly take some comfort from an exoneration clause but overriding pensions legislation says it can't protect them if they have breached their investment duties. What a trustee really must know to comply with those duties to avoid losing his house is:

1. The starting point is that pensions legislation gives pension scheme trustees the same power to invest as if they owned the scheme assets personally, but this is subject to certain statutory requirements and any restrictions in the scheme rules.

2. The 12 statutory requirements are:

(i) get prior written advice about an investment's suitability and how compatible it is with the scheme's statement of investment principles (a 'SIP') and consider how often you should review that advice;
(ii) act in the best interests of members, and if there is a conflict, in members' sole interests;
(iii) invest "in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole";
(iv) the scheme assets held to cover 'technical provisions' (i.e. up the level needed to meet statutory funding level) must also be invested "in a manner appropriate to the nature and duration of the expected future retirement benefits payable". In other words, you should have an eye on the scheme's liability to pay benefits over time when working out how to invest the assets that will be needed to fund those benefit payments;
(v) the assets must be predominantly invested in regulated markets;
(vi) you must "avoid excessive reliance on any particular asset, issuer or group of undertakings so as to avoid accumulations of risk in the portfolio as a whole";
(vii) only use derivatives to reduce risk or "facilitate efficient portfolio management (including the reduction of cost or the generation of additional capital or income with an acceptable level of

risk)" and avoid excessive risk exposure to one counterparty;
(viii) the scheme can't borrow (unless for short term liquidity reasons) or act as guarantor for someone else's obligations;
(ix) investing in employer-related assets is severely limited, so exercise extreme caution and get lots of advice before ever going down that route;
(x) you must exercise your investment powers "with a view to giving effect to the principles" contained in the SIP "so far as reasonably practicable";
(xi) you must consult the employers on preparation and revision of the SIP, and consultation has to be a proper dialogue; and
(xii) you must review the SIP if there is a change of investment strategy and at least every 3 years.

What about making the wrong judgement call on investment strategy?

The courts around the world have been remarkably sympathetic where trustees have been undone by falling markets. For example in a US case a family trust fund lost about 90% of its value during the 1970's oil crisis but the judge let the trustee off and said:

"it is not inherently negligent for a trustee to retain stock in a period of declining market values nor is there any magic percentage of decline which, when reached, mandates sale" (Stark v US Trust Co of New York ([1978])

What if the employer needs a favour on the investment front in times of trouble?

Again, the courts have been pretty supportive as long as it is done for the right reasons i.e. for the long term benefit of the scheme members. In Withers v Teachers Retirement System of New York (1978), some $2.5 billion of pension assets were invested in unmarketable and highly speculative New York City (the scheme employer) bonds to save the City from bankruptcy. The court held that this was acceptable because it was in the best interests of beneficiaries, because if the City went bust there would be no further funding for the scheme.

And it's not just New York judges being helpful. In the UK (in Evans v London Co-operative Society (1976)) a pension scheme member (who happened to be a milkman) complained about the trustees making a loan to the employer at a preferentially low interest rate. Although pension schemes are now banned from making such loans it is interesting to note the judge said something quite broad and potentially useful in other situations:

"it would in my view be wrong to suppose that the trustees are forbidden to give a parent concern financial accommodation on preferential terms if the trustees consider that the security of the employment of their members may otherwise be imperilled"

Other investment-related risk

The other liability exposure on the investment front is just failing to get things done in a timely manner. Particularly where defined contribution benefits are concerned, delays in executing member instructions or trustee decisions can lead to losses and to the extent that is a breach of trustees' investment duties then they could be liable. So trustees must make sure their administrators work to suitable timescales and get them to report any anticipated delays immediately, and if they get it wrong then they should cover any member losses.

If a trustee follows the advice above, they have absolutely nothing to worry about!

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McLean's Guide for Trustees & Companies

Do's and Don'ts for DB & DC Schemes

Malcolm McLean OBE, *Consultant, Barnett Waddingham*

I was very pleased to be given the opportunity once again to speak at the OPDU Annual Risk Conference.

There are so many facets to the topic of "pension risk" and for the second year in succession the conference agenda was skilfully put together so as to allow all the different themes and issues to emerge seamlessly and with very little, if any, speaker overlap. Quite an achievement in all the circumstances.

For my session I was invited to set out some "Do's and Don'ts" for employers and trustees in both DB and DC schemes as viewed from a member perspective. This is frankly the sort of remit that makes you feel it necessary to start with a blank piece of paper and then hopefully with the help of others brainstorm the subject until you have, after a series of edits and redrafts, something approaching a sensible list.

And that is more or less what I did. I spoke to as many scheme members as I could - in one instance utilising a local radio phone-in programme to ask listeners what they expected of the people running their pension scheme – as well as colleagues and others within the pension industry.

What came across very strongly in looking to compile my "Do's" list was the concern that many consumers still have about the security of pension plans – how safe would their money be, what guarantees could they be given, and so on? Clearly the well publicised scandals that have hit pensions over recent years have had an impact and left lingering doubts in the minds of many about security.

There was also concern expressed about the complexity of the pension system as a whole and the seeming inability of many schemes to explain things simply and in a language that ordinary people can understand.

In relation to security and member protection this is clearly an area where whatever assurances can be given should be given - to members and would-be members as well. It came as something of a surprise to me how many people seemed to be aware of the losses incurred by members of defunct pension schemes where the company had gone into liquidation but did not know of the existence of the Pension Protection Fund and the cover that now provides.

The role of the trustees in running the scheme, ensuring security and generally acting in the best interests of the members also does not appear to be fully appreciated although there does seem to be an expectation that someone will be carrying out that function.

Members of pension schemes probably need general assurances rather than detailed ones. As one scheme member put it to me very pointedly

"Look, I joined my company pension scheme to get a pension when I retire. No more and no less than that. I want my pension to be there for me when I need it. I don't want to be bothered with a lot of operational detail – just make sure my pension's safe and secure, that nobody's ripping us off and assuming we continue to pay our dues we get what we've been promised."

Communication is an on-going issue within the pensions industry and standards do appear to be variable. The language of pensions is often impenetrable to members and I know from my experience can itself lead to misunderstandings and disputes which really ought not to arise. Trustees have a responsibility to ensure the highest possible standards are maintained in this respect and in the delivery of customer service generally.

Not surprisingly therefore the need for good timely and accurate communication as well as security considerations and assurances all feature strongly on my "Do's" list.

On the "Don'ts" front, amongst other things, I have taken the opportunity to remind trustees (and employers) of the need not to underestimate the role of administration in delivering that required good customer service and indeed avoidance of disputes with members generally. Similarly I have issued a cautionary note about not being too gung-ho in pursuing recovery of large overpayments of pension with potential PR consequences for the scheme. There have been several cases featured in the media recently where the image and reputation of the scheme has emerged rather tarnished from their handling of what is after all an issue which needs to be approached with some sensitivity. I have also suggested that trustees and employers should have nothing to fear from the various regulatory authorities and ombudsmen – assuming, of course, their actions (the schemes not the authorities) are honest and above board – and should work with them not against them in their own best interests.

The full lists of my Do's and Don'ts are as shown. As I hope I made clear at the conference these can never be definitive lists as priorities will vary from scheme to scheme and will in any event need to be reviewed to take account of the major changes in the pipeline – abolition of the default retirement age and auto-enrolment/NEST to mention just two. With many more people expected to be contributing to pensions in the future, however, I would expect there to be a greater consumer focus not less and that will inevitably influence all our actions going forward.

Ten Do's

1. Ensure that the pension funds are safe and secure and kept separate from the employer's monies.
2. In the event of the company going bust and/or the scheme being wound up pension rights and entitlements will not be lost.
3. The employer as the plan sponsor will ensure that any DB scheme is appropriately funded at all times.
4. The employer will contribute to each individual DC pension as promised and on time.
5. The trustees will satisfy them selves periodically as to the strength of the employer's covenant.
6. An appropriate default option arrangement will be provided for those DC members who do not wish or feel competent enough to make an investment choice from the range of funds on offer.
7. The trustees will act in the best interests of the members at all times.
8. Communication with members will always be timely, accurate and clear.
9. Members will be informed of all proposed changes to their scheme and be invited to comment on them where appropriate.
10. A formal internal disputes procedure will be available to all members.

Ten Don'ts

1. Don't treat members as after thoughts – they are your ultimate customers.
2. Don't underestimate the work of administrators – they are a front line not a back office service.
3. Don't be obscure or opaque in explaining scheme rules, annual management charges etc.
4. Don't discourage members from asking questions about their pensions or the workings of the scheme generally.
5. Don't start off by denying a member's complaint without full and proper investigation of the facts.
6. Don't send out stupid, incomprehensible letters of explanation to scheme members.
7. Trustees – don't be complacent about the standards of customer service being delivered by the scheme. Seek independent feedback where necessary.
8. Don't be unaware of the potential PR consequences of pursuing recovery of large overpayments.
9. Don't get confused about the roles of the different regulatory bodies and ombudsmen – and don't be afraid of them. They should be there to help not hinder.
10. Don't ever be afraid of number 10. The occupant will always be a bigger threat to the longevity of the Pensions Minister than to you or your members.

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Protection: Indemnities, Exoneration & Insurance

Mark Howard, *Partner, Barlow Lyde & Gilbert LLP*

The Pensions Act 2004 requires trustees to operate internal controls to ensure that the scheme is run in accordance with its rules and the law. Trustees are recommended to carry out a risk analysis to identify the controls they should operate. But how many trustees carry out a risk analysis of their own personal liability as trustee? What protections are available for trustees?

Indemnities

Trustees are personally liable for the contracts that they enter into, but they have a statutory indemnity under the Trustee Act 2000 for the expenses incurred in running the scheme.

The scheme rules may provide a further indemnity – either from the trust fund or the sponsoring employer – which goes further and applies when the trustees are fixed with some liability. However, there are limits to how far an indemnity from the fund may go: section 33 Pensions Act 1995 prevents an indemnity operating in relation to investment duties and section 256 Pensions Act 2004 prevents indemnification for civil penalties or fines (or paying the insurance premiums which would cover such loss).

Exoneration clause

Indemnities protect trustees from the financial consequences of any wrongs committed. Exoneration clauses excuse the trustees from the very behaviour which would otherwise attract personal liability. Exoneration clauses are restrictively interpreted and the scope of exoneration clauses (if any) varies from scheme to scheme. Typically an exoneration clause will be expressed as not applying where there is "fraud or dishonesty", "wilful default", or a "breach of trust in personal conscious bad faith". This last example would protect trustees where they carry out a "judicious breach of trust": deliberately acting outside of their powers with the intention of benefiting the members.

Corporate Trustees

A corporate trustee structure provides further protection as the individuals running the scheme are protected by the corporate veil. In the pensions case HR v JAPT (1997) it was argued that directors could be indirectly liable to members; but that approach appears to have been finally rejected following the case of Gregson v HAE Trustees Limited (2008). The position now appears settled that directors of a corporate trustee are insulated against from claims by members unless for "accessory liability" where they have dishonestly assisted in the corporate trustee committing a breach of trust or for offences or civil penalties imposed under the Pensions Acts.

Statutory protections

Section 61 Trustee Act 1925 allows the Court or Pensions Ombudsman to relieve a trustee from liability for breach of trust where the trustee "has acted honestly and reasonably, and ought fairly to be excused". It has been used in the pensions context, but trustees should draw little comfort from it as it requires the exercise of a discretion in their favour after the event.

Pension Trustee Liability (PTL) Insurance

Most PTL policies are drafted on the basis that the policyholder is the sponsoring employer. If the employer purchases the policy it can cover fines and penalties which would not be allowed if fund assets were used. However, where the sponsoring employer is either unwilling or unable to purchase insurance, trustees may still want to purchase indemnity insurance. The raises the question of whether - absent an express power in the deed and rules - they would have power to do so. This courts have considered this in the context of schemes in winding-up, when trustees have sought to purchase run-off cover to protect themselves from claims which might arise after all of the fund assets have been paid away to secure members' benefits.

In *Kemble v Hicks* (No 2) (1999) the Trustees wanted insurance to cover claims of breach of duty committed in good faith and overlooked beneficiary insurance. There was no express power to purchase insurance and there was a wide exoneration clause. The High Court held that the cover for breach of duty would only benefit the trustees and therefore was not a necessary expense, so scheme assets could not be used to purchase the insurance. However, missing beneficiary insurance could be purchased as a cost of administration as it would avoid the need to set aside a reserve fund to meet possible future claims

The High Court considered this issue again in *NBPF Pension Trustees Limited v Warnock-Smith* (2008) which concerned, to quote the judge, "the last knockings" of the two National Bus pension schemes. The Court approved a final distribution of surplus assets in the two schemes which included barring any future claims of beneficiaries currently unknown to the trustees. As with *Kemble v Hicks*, the Trustees wanted insurance against claims for breach of trust and cover for overlooked beneficiaries. The arguments against the purchase of insurance were similar: there was limited benefit to the members of the purchase of insurance. However, in this case the Court was prepared to sanction the purchase of run-off liability insurance.The key distinction appears to be that as no exoneration clause applied, the trustees could be liable for innocent breaches of trust, which in turn meant the insurance could benefit members of the scheme. In relation to the missing beneficiary insurance, the trustees were justified in buying insurance for those members who were known to the trustees, but for whom, erroneously, no provision had been made. But missing beneficiary insurance for unknown beneficiaries – who the court had barred from bringing future claims - could not be covered as their claims would be doomed to failure and the purchase of cover would therefore be of no benefit to members.

Both cases concerned cover once the scheme had completed winding up and where there was no express power to use fund assets to buy a PTL policy. If the scheme is on-going, it might be easier to justify the purchase of a PTL policy as an administrative expense as it would encourage trustees to remain in post, which is a benefit for members. This could also be used as the justification for amending the rules to allow insurance to be purchased regardless of whether the policy is of direct benefit to the members of the scheme.

What does Pension Trustee Liability Cover?

PTL policies operate on a "claims made" basis. This means that the insurer indemnifies for any claim made against the insured during the policy period - typically a year - irrespective of when the event giving rise to the claim occurred.

As is well known, contracts of insurance are contracts of utmost good faith. An insured must avoid making false statements in the proposal form and also disclose all material facts. Failure to do so may mean the contract is avoided by the insurer if the misstatement or failure to disclose would have been material as to whether the underwriter would have taken on the risk. Problems in a pension scheme can lay undiscovered for a number of years, so an insurer will always look carefully at whether there was full disclosure either on original inception or on renewal.

Most PTL policies will contain wording limiting the knowledge of one party being imputed to another for the purposes of non-disclosure. One or two contain "innocent non-disclosure" clauses where the insurer waives the right to avoid the policy except in cases of fraudulent non-disclosure. These clauses can be significant since, where a right to avoid the policy might otherwise arise, they restrict such draconian effect and can protect those insureds not responsible for the non-disclosure or misrepresentation.

Policies will also allow an insured to notify the insurer of circumstances which may give rise to a claim in the future. Any subsequent claim arising from those circumstances is then covered. Provisions relating to notification of circumstances are designed to prevent the risk of a claim falling between two policies as, at the renewal of the policy, the circumstances would have to be disclosed to insurers and the succeeding year's cover will almost certainly exclude liability in respect of any circumstance previously notified to insurers. For example, trustees take out a PTL policy commencing on 1 January 2011 for one year with Insurer A. During 2011, they carry out a data audit to comply with the Pensions Regulator's requirements and discover a number of problems and that incorrect benefits have been paid. However, at this stage there is no claim by a member against the trustees. For 2012, the trustees want to take out a policy with Insurer B, but when the data problem is disclosed in the proposal form, Insurer B limits the policy to exclude any claims arising out of it. The trustees should take advantage of the notification of circumstances clause in their contract with Insurer A, which will mean that Insurer A would meet any claims brought in relation to the data audit (subject to the other terms of the contract) even if they are made after the end of the policy year.

The cover and the insured

At its simplest, PTL insurance provides an indemnity for the "insured" for any "loss" suffered as a result of a "claim" for a "wrongful act". However, it would be wrong to assume that PTL insurance just covers the pension trustees. PTL policies are usually contracts of "composite insurance"; each insured has, in effect, a separate contract with the insurer albeit contained in the single policy document. The extent of cover varies from policy to policy and should be reviewed carefully, but the following categories may be covered.

Trustees' loss for claims for a wrongful act

"Loss" is often defined to include not only damages or settlements, but also defence costs of defending and investigating the claim. The cover for defence costs can be very significant; especially if the insureds require separate representation. A "claim" is typically defined in terms of a written demand for damages or assertion of a legal liability against an insured or the start of court proceedings. "Wrongful Act" will usually be widely defined to include any breaches of trust or duty, maladministration, mis-statement, negligence or omission in relation to the scheme.

Employees' loss for claims for a wrongful act

"Employees" is usually defined in terms of being an employee of the sponsoring employer and this would cover an in-house pensions manager.

Sponsoring employer's loss for a claim for a wrongful act

Careful reading of the policy is required as subtle differences in policy wording can limit the cover available. For example, one insurer defines "Wrongful Act" in terms of acts or omissions committed "in relation to" the pension scheme. This would be wide enough to cover the employer's liability under, for example, a contribution notice imposed by the Pensions Regulator.. However, another insurer has a definition of "Wrongful Act" which is very similar, apart for the crucial difference at the end that it relates to a claim "against an Insured solely by means of their status acting on behalf of the Pension Fund." This appears to restrict the cover for the sponsoring employer to where it is acting as agent for the trustees, for example by the provision of administrative services.

Sponsoring employer's or the Scheme's loss in indemnifying trustees

This means that the trust fund is not harmed by indemnifying the trustees against their personal liability.

The Scheme's loss as a result of exoneration of trustees

This is an area where there is some divergence amongst insurers. Some insurers do not cover the scheme for its loss, where the trustees are exonerated from their breach of trust

Pensions Regulator investigations

Cover can also be provided for the costs of dealing with the Pensions Regulator (or indeed any other official body). The trigger for cover is usually a "formal" or "official investigation" – which should be long before a warning notice is issued by the Regulator.

Exclusions

The most important exclusions of cover under PTL policies are:

Dishonesty and fraudulent conduct

Insurance protects against contingencies, so it is only to be expected to find exclusions against fraudulent, dishonest or criminal conduct or the gaining of any profit or advantage to which the insured was not legally entitled. This exclusion will generally not apply until there is a final judgment on the conduct of the insured, which means that defence costs will continue to be met until that time – but the insurer will usually seek to recoup the costs if the insured is found to be dishonest.

Pending and prior litigation

This excludes not only any litigation or pending litigation prior to when the insurer first went on risk, but also any claims alleging the same facts or circumstances. Those claims should be covered under any previous PTL policy which is covering the litigation following a notification of circumstances.

Failure to Fund

All PTL policies contain a "failure to fund" exclusion – there is clearly a moral hazard for the insurer regarding the coverage of scheme funding. Even though "failure to fund" is an exclusion common to all PTL policies, there are differences in its scope. Cover will sometimes be available for a negligent failure or where an individual trustee would be personally liable.

Benefits

Most policies will contain some form of exclusion that benefits payable by the scheme will not be covered, unless they become the personal obligation of an individual. Again, there is a moral hazard reason for this – the PTL policy should not cover benefits which should have been paid in any event.

Other common exclusions

Other typical exclusions under PTL policies include environmental losses (although defence costs may be covered); taxes and fines (but excluding Pensions Regulator fines and penalties); claims outside of the UK; property damage; and personal injury.

Retired Trustees and Extended Reporting Periods

Most policies define a "trustee" as including individuals who have ceased to be trustees In addition, if a policy is not renewed or similar cover enacted, trustees who retired before the end of the policy period will usually remain covered for a specified period at no extra premium. The reason for this is that the retired trustee will no longer be in a position to influence whether cover is maintained. However, the cover can vary from insurer to insurer: from 12 years* at one extreme to 12 months at the other and there are sometimes conditions as to the circumstances leading to the retirement of the trustee.

Policies will also give the opportunity for an extended discovery period to be purchased if the policy is not renewed or replaced. This will cover the insured for any claims made during the extended discovery period which relate to wrongful acts before the expiry of the policy period. The policy schedule will usually state at the outset the premium required for an extended discovery period.

Change of risk

Policies will usually provide coverage for schemes acquired after the policy period has begun. But this can represent a significant change in the risk that the underwriter had agreed to cover. To reflect this, the cover for "after acquired" schemes may only be provided for a three month grace period before separate cover must be agreed. Alternatively, cover may be granted for the remainder of the policy period if the assets of the after acquired scheme are less than a specified percentage and, if they are more, then cover will be provided for a grace period before new terms must be agreed. The "wrongful acts" covered may also be limited to those after the scheme was acquired by the employer.

Policies sometimes limit cover if the sponsoring employer is subject to a merger or takeover to wrongful acts prior to such event. It should make no difference to the risk of claims against the trustees – which is really a factor of size and management of the scheme – whether the ownership of the employer has changed. From the insurer's perspective, the rational is the scheme should be covered under the acquiring employer's PTL policy. However, some insurers have recognised that change of employer should make no difference and have removed it from their standard wordings.

Conduct of Claims and Subrogation

The insurer will retain a right, but not a duty, to defend a claim. The insured on the other hand will generally be placed under a duty to defend the claim and not do anything to prejudice the defence of the claim or agree any settlement without the prior consent of the insurer. This can lead to tension between insurer and insured as to whether a claim should be defended. Insurance contracts sometimes contain a "QC clause" where both parties agree to be bound by the opinion of a Queen's Counsel as to whether the claim is defendable. The insurer will be subrogated to any claim that the insured has against another person. Of course, the subrogated claim could be against another insured. One or two insurers expressly exclude subrogated claims against another insured (absent criminal or dishonest behaviour). Most retain wide rights to bring subrogated claims.

Extensions

There may be other areas of cover, but whether they are provided may depend on whether they are expressly stated in the policy schedule and an extra premium paid. In some policies this cover is automatically included. Examples of this include:

- Costs of dealing with lost documents
- Costs of bringing a court application for construction of the deed and rules
- Costs of bringing negligence proceedings against an adviser
- Emergency defence costs – when the prior consent of the Insurer to incurring defence costs cannot be obtained
- Pensions helpline for trustees
- Theft.

Conclusions

The protections that are available for trustees may vary considerably from scheme to scheme. If trustees do have insurance, they should also ask themselves how well do they understand its terms and does it really meet their needs. Are the requirements for reporting claims and notification of circumstances provisions under the policy clearly understood? Failure to report at the right time could mean that there is no cover for the claim. What procedures are in place to ensure the correct information is provided on renewal? If insurance is currently purchased by the employer, would the trustees be able to renew the policy if the employer is no longer willing (or able) to continue cover? Trustees should not only assess the risks for members, but also the risks they personally run.

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*See page 3 Bulletin Board: New Cover Enhancements to the OPDU Elite Policy.

Protecting Trustees from Litigation Costs

Helen Smith, *Senior Broker, TheJudge*

No-one wants to become embroiled in litigation, particularly when an unsuccessful outcome could result in significant expense and put pension fund assets at risk.

Trustees are of course obligated to investigate any such claims. However, such financial risks can often be a barrier to pursuing litigation altogether, meaning that losses suffered as a result of the actions of a third party are simply written off.

Fortunately, there are solutions available to mitigate some or all of the cost risk of pursuing a recovery, namely by the application of after the event ('ATE') insurance and Third Party Funding.

What is ATE insurance?

ATE insurance is a policy of indemnity that protects a client from the cost consequences of an unsuccessful outcome in legal proceedings. Accordingly, the insurer does not pay the legal fees on a day to day basis but rather indemnifies the cost incurred in the event that the case is unsuccessful.

Whether the trustees are pursuing a third party in relation to negligent advice, breach of contract, misrepresentations or fraudulent activity, ATE insurance will cover the potential adverse costs that the trustees could face in the event that the legal proceedings are lost. In addition, coverage can normally be extended to insure some or all of the insured's own side legal costs in the event that the case is lost.

Applications for this specialist class of insurance can be made at any point once a prospective insured (pension trustee) becomes aware they have a legal claim which they wish to pursue. Accordingly, the insurer's decision as to whether or not to offer coverage is solely based on the prospects of succeeding in relation to that particular dispute.

Albeit in a very different form, this class of insurance was historically limited to small value personal injury and clinical negligence claims. The market has widened substantially in the past five years however, as a result of more and more large insurance companies entering the ATE market with a primary focus and specialism on commercial litigation.

Whilst there are obvious benefits to ATE insurance policies for financially distressed clients who seek to 'level the playing field' with a well-resourced opponent, many of the world's largest companies have used ATE insurance as a hedge on their legal cost exposure in order to bring balance sheet certainty to their legal spend.

With regards to the indemnities available, these can range from less than £250,000 up to more than £20,000,000 in respect of any one case.

A key advantage of ATE Insurance is that the premium payable is deferred to the conclusion of the case and is contingent upon success. In other words, a trustee pays nothing upfront in return for the cover and nothing in the event that the case is unsuccessful i.e. if the case loses; the insurer pays a claim and does not receive a premium.

Where the litigation is pursued in England and Wales, an additional benefit exists in that the ATE premium is deemed a recoverable cost under section 29 of the Access to Justice Act 1999, subject to reasonableness.

A fair degree of sophistication applies to the pricing of insurance premiums. For example, to combat the risk of an insured paying too much (i.e. because the case settled early), insurers will typically offer generous discounts in the event of an early conclusion to the claim, to reflect the reduced costs exposure faced by the insurer at that point.

What is Third Party Funding?

ATE insurance policies will provide costs protection in the event of an unsuccessful outcome. However, they will not finance costs on an interim basis, save for any interim adverse costs which may be ordered.

To combat this issue, a Third Party Funding model has evolved whereby an external investor provides the necessary cash-flow in order to pursue the litigation or arbitration. In return for this investment, the funders will charge a financing fee.

Similarly, to the ATE insurance premium, this financing fee is typically payable at the conclusion of the dispute and only in the event that the trustees are successful. However, unlike the ATE premium, the financing fee is not a recoverable cost in England & Wales and will therefore inevitably be paid from the damages recovered by the trustees.

What degree of involvement do Funders/Insurers take in the litigation?

One similarity that exists between both insurers and funders is that neither will take any active involvement in the running of the litigation. The obligations on the claimants are predominantly limited to reporting material developments, e.g. the receipt of settlement offers from the opponent.

Risk transfer options in pensions litigation

Any individual or organisation which is contemplating legal proceedings has a lot to consider in terms of the potential cost consequences. These risks can be particularly significant with regards to pension litigation where the trustees have to consider the potential adverse effects that the litigation could have on the pension fund assets.

The types of pension litigation claims that are typically considered by the market of litigation insurers and funders is diverse and ranges from interpretation of pension scheme documents, breach of trust claims, constructive trust, breach of fiduciary duty, insurance coverage and professional negligence.

The mix of risk transfer options that might exist for a given case can vary. Funding and insurance arrangements will be tailored to the case in question. For example, well resourced litigants may not require litigation funding. However, having an insurance policy that will reimburse the costs expended if the case loses remains an attractive risk mitigation tool.

It could be that some litigants are comfortable in taking the risk on their own fees but are solely seeking to insulate themselves against the risk of having to pay opponent's costs, the level of which can be less predictable. Adverse costs only insurance affords this protection and is readily available within the marketplace.

A tactical advantage?

There are other potential benefits to having an arrangement with a litigation insurer/funder beyond the obvious risk mitigation advantages.

A trustee who secures an after the event insurance policy is obliged to notify the opponent of the existence of the same, assuming that the policyholder wishes to seek to recover the insurance premium inter partes, upon success.

Not only does this notification put the opponent on notice of a potential additional liability they will face if they lose, it can also serve to reinforce the perceived strength of the claimant's case. For example, it could indicate that a large A-rated insurance company has independently considered the merits of the case and, having done so, has agreed to commit them-selves to risk. This can serve to make even the most entrenched defendant question their own advisors assessment. Quite often the mere serving of Notice of Funding to an opponent can initiate a channel of communication towards settlement.

Within the Notice of Funding to be served on the opponent notifying them of the existence of the policy, the trustee would also be obliged to disclose the staging of the premium itself. Whilst avoiding informing the opponent of any pricing details, any settlement discounts in the premium or increases triggered by certain stages within the litigation need to be disclosed. This can often focus the opponent's mind in terms of timing a settlement offer; they shall be aware that an early settlement will result in a lower premium payment.

The application process for insurance/funding

There are two principal methods available to secure ATE insurance or third party funding. Via their lawyers, a prospective litigant can either apply directly to insurers and funders or alternatively engage a specialist broker.

Whichever option a claimant chooses, it is prudent to ensure that multiple markets are approached. Not only does this ensure the trustees can determine the most competitive offer, it also protects them against the adverse effects of approaching one insurer and then another. Taking the latter approach can prejudice the ability to secure an offer since, if the first insurer declines to offer terms, that decline needs to be disclosed to the next insurer which can be prejudicial to the chances of securing an offer of cover. The safest way to combat this issue, unless there are compelling reasons to do otherwise, is to approach providers simultaneously. As the largest specialist broker in the industry, we always approach multiple markets simultaneously for this very reason.

Once the route to market has been determined it will be necessary to complete an application pack for the insurance and funding providers. This pack will typically include:

A detailed Case Summary

Copies of any Pleadings and/or Counsel's Advice will naturally provide some background information into the dispute in question and may even give a helpful chronology, meaning that insurers and funders can bring themselves up to speed very quickly.

Our extensive experience suggests however that a case summary from the engaged legal team, outlining the current procedural position, the strengths and weaknesses of the case and their tactical plan going forward can be invaluable. It can serve as a useful tool for the lawyer to navigate the assessor to relevant documents.

We often find that pre-empting any arguments from the opponent and providing counter-arguments in response to the same can mitigate the number of further information requests an underwriter or funder needs to make.

Ultimately insurers and funders need to form their own view on merits before agreeing to offer terms, and therefore any assistance that can be given by the engaged lawyers can vastly speed up the due diligence process.

Provide an assessment of likely claim value and the prospects of enforcement

A realistic estimate of the likely damages award will always be requested. Funding providers in particular will likely require quantum evidence detailing the calculations carried out and the verification behind them.

Both insurers and funders will be interested in what investigations have been undertaken regarding the financial viability of the opponent, particularly as it will ultimately be the funder and/or insurer carrying the enforcement risk. For example, if a case succeeds at trial but it proves impossible to enforce against the opponent due to their insolvency, most insurance policies would treat such an eventuality as a loss under the policy and therefore pay a claim in relation to the insured costs.

Other supporting documents and cost budget

In addition to the case summary, the markets will typically want sight of any material documentation that exists.

Whilst they will not typically need to consider all of the documentation available, they will require copies of pleadings, expert reports, material pre-action correspondence and anything else that an independent third party would reasonably need to form their own view of merits.

A detailed cost budget from the engaged legal team will also provide confidence that the estimates given are well reasoned, albeit the markets appreciate that these approximations will be under constant review.

Summary

Any trustees considering pursuing a legal claim against a third party ought to be alive to modern risk transfer options in order to mitigate the legal cost exposure of doing so.

Some lawyers are still struggling to keep up with available options in what is a fast developing marketplace; it is therefore imperative that prospective claimants insist on an informed discussion on the subject at the outset, particularly where the claimant owes a duty to others to mitigate the risks and costs of a particular course of action.

If there is one key message to take away it is this; regardless of the size of the case, if it enjoys good prospects of succeeding (typically 60%+) then there is likely to be a variety of products available to remove some or all of the trustees' cost exposure and crucially without costing anything at the outset. Fees are typically only payable if and when the case succeeds and the litigant has actually recovered monies.

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The IPA Portable Pension Plan
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