OPDU

Protecting Trustees Pension Schemes and Sponsoring Employers

Report 28
2011

OPDU
IS MANAGED
BY **THOMAS**
MILLER

OPDU

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Bulletin Board

OPDU Annual Meeting held at

Shock, Denial and Anger at OPDU Annual Meeting!

Lindsay Tomlinson, Chairman of the National Association of Pension Funds (NAPF), drew upon the Kubler-Ross Grief Cycle of shock, denial, anger, depression and acceptance, to describe how the pension industry body had undergone an identity crisis in adapting to significant change affecting UK pension provision. It had emerged stronger, with a clear objective of promoting workplace pensions' saving. In announcing the launch of the Workplace Retirement Income Commission, an independent body supported by the NAPF, he confirmed that its objectives included investigating and reinvigorating workplace retirement savings, with the aim of building a consensus around the proposals.

Jonathan Bull had given a welcoming introduction to the audience of more than 100, containing many eminent people from the world of pensions.

Peter Murray, Chairman of **OPDU**'s Advisory Council, then summarised the work **OPDU** had undertaken in the last twelve months in an environment which remained challenging for both trustees and companies. **OPDU** continued to provide the most comprehensive cover and support, including protection for several thousand trustees. It had seen its membership grow to more than 750 schemes with assets in excess of £180 billion held in trust. He highlighted **OPDU**'s ability to now routinely provide up to £30 million of cover, which was twice the market norm for primary insurance limits, as well as its ability to meet the insurance needs for schemes being discontinued or wound up. Peter Murray concluded his address by highlighting examples of recent claims and notifications in order to illustrate areas currently giving rise to problems.

Reed Smith – 3rd Febuary 2011

The final presentation from David Taylor, Director of Legal Services at the Pension Protection Fund set out the growth of the Fund, changes in its funding position and proposals for future funding which it obtained from levies on eligible schemes. Its aim was to achieve greater predictability and stability for its levies. He summarised a number of court cases involving the Pension Protection Fund and finished by stressing the importance of schemes having accurate data and the pitfalls where this was not the case.

Both speakers paid tribute to the work of **OPDU** in protecting and educating trustees of occupational pension schemes.

Following a lively question and answer session, a reception was held with Reed Smith's offices providing panoramic views of the London skyline at night.

NEST

OPDU is delighted to have won the tendering process with its underwriters ACE in which the leading providers of pension trustee liability insurance were invited to participate to provide insurance for the trustees of the occupational pension scheme run by NEST Corporation. NEST (National Employment Savings Trust) is the new low cost pension scheme any employer can use to meet new legal duties that will be introduced from October 2012.

While the breadth of cover, pricing and the strength of ACE's underwriting were obviously important factors in the selection process, it is pleasing to note that **OPDU**'s technical ability, claims service, quality of ongoing support and risk management capabilities were also considered to be important.

Jonathan Bull commented "we look forward to supporting NEST and its trustees in its mission to put scheme members first and to meet the needs of people who are largely new to pension saving and their employers".

OPDU Elite Policy Wording

OPDU regularly reviews its policy wordings with its underwriters to ensure that it continues to provide comprehensive cover to meet the changing needs of schemes including those regrettably facing wind-up. Therefore, **OPDU** will be pleased to assist whether the insurance needs relate to a current scheme or one that is being wound-up and the trustees and employer require discontinuance or run-off cover to protect them against their potential liabilities.

2010

During the year **OPDU** exhibited at the NAPF Annual Conference and Professional Pensions Show which were held in Liverpool and London respectively. The exhibitions gave rise to a number of positive enquiries but regrettably many trustees remain unsure of their insurance arrangements or whether they have any insurance. Accordingly, we continue to try to raise understanding of the risks to which trustees are exposed and the claims encountered in order that those becoming trustees are better able to decide upon appropriate protection. **OPDU** regularly attends trustee training sessions to assist in this respect and please contact us if you would like to arrange for us to participate in training.

Insurance Cover for Court Application Costs

There has been a continuing increase in **OPDU** members adopting the Court Application Costs extension which is optional cover for when the trustees are advised to seek directions or a declaration from the court as to the future conduct of matters or the interpretation of trust documents. It is usual for interested parties to be represented by separate lawyers and all costs have to be met out of the pension scheme's assets which are covered by this extension.

www.opdu.com

We will shortly be completing a major review of our website to improve the various interactive features on the site in view of the heavy demand and the amount of the information being downloaded. Please visit the web Bulletin Board for the latest news and you can also find all the articles which have appeared in the previous issues of the **OPDU** Report, together with membership information.

OPDU IS MANAGED BY **THOMAS MILLER**

*Founded in 1885, Thomas Miller provides world class insurance services in three main areas: Transport, Professional Indemnity and Specialist services. We grew out of the transport sector, but our professionalism and creativity has led us to expand into other areas. The services we offer make use of our core skills in underwriting, claims handling, loss prevention, risk management, legal advice and investment. We are well known in the UK for managing insurance services for barristers, patent agents, housing associations and pension fund trustees (***OPDU***). Our success in this field is due to a thorough knowledge of our clients' businesses and the issues facing them.*

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OPDU - Protecting Pension Schemes

OPDU protects pension schemes by providing unique insurance cover to trustees, administrators and sponsoring employers. Pension schemes holding total combined assets in excess of £180bn have joined. The membership ranges from large funds to small, with over 750 schemes covered.

OPDU's members can readily purchase limits of cover between £1m and £30m or higher limits can be arranged if required. The cover has been developed for the special insurance needs of pension schemes but can be varied to meet the specific requirements of individual schemes.

OPDU affords a valuable external resource for reimbursing losses suffered by pension schemes. The asset protection thereby given is ultimately of benefit to pension scheme members.

In accordance with our clearly stated objective of helping to raise standards in pension scheme administration, we offer a confidential Advisory Service and assist trustees with a risk-based approach to their duties.

OPDU's unique structure includes The Advisory Council. Elected by the membership, The Advisory Council's function is to ensure that the services and insurance provided continue to meet the changing needs of members.

OPDU is managed by Thomas Miller, the world's leading independent manager of mutual insurance companies, including schemes for professionals such as barristers, solicitors and patent agents.

OPDU's insurance cover is underwritten by ACE European Group Ltd.

Insurance Cover

Who is insured

To achieve our aim of insuring everyone who might become liable for a loss as a result of internal maladministration of the pension fund, the insured has been broadly defined to include:

- Trustees
- Corporate Trustees
- Directors of Corporate Trustees
- The Pension Scheme
- Sponsoring Employers
- Internal Advisors
- Internal Administrators
- Internal Dispute Managers

This helps to reduce internal conflicts and eliminate disputes between insurers representing different interests.

What is covered

To achieve our aim of providing an external resource for reimbursing losses suffered by the pension scheme, even in some circumstances where no person is legally liable for the loss, the cover provided is broad and includes:

Errors and omissions

Trustees and employees engaged in the administration of the pension scheme are covered for losses suffered as a result of wrongful acts, such as breach of trust, negligence or misrepresentation.

TPR civil fines and penalties

Trustees, employees and sponsoring employers are covered for civil fines and penalties imposed by The Pensions Regulator and for legal costs incurred in connection with TPR investigations and prosecutions.

Ombudsman complaints

Trustees, employees and sponsoring employers are covered for awards made by the Pensions Ombudsman and for legal costs incurred in defending determinations and appealing his decisions.

Defence costs

Trustees, employees and sponsoring employers are covered for legal costs and expenses incurred in defending claims brought against them in connection with their duties to the Pension Scheme. These costs can include references to alternative dispute resolution and arbitration, third party costs and investigatory costs.

Employer indemnities

Where the sponsoring employer is required to indemnify a trustee or employee, the cover reimburses the employer for the indemnity, thus offering valuable balance sheet protection.

Exonerated losses

Where persons cannot be held liable for Net Loss caused to the pension scheme by wrongful acts as a result of being excused by exoneration clauses in the trust deed, the policy can nevertheless reimburse the loss to the pension fund under its Net Loss cover.

Court Application Costs

Sometimes issues arise where the trustees are advised to seek directions or a declaration from the court as to future conduct of matters or the interpretation of trust documents.

Normally several interests have to be represented by separate lawyers and all parties costs have to be met out of the pension scheme. Optional cover is available to reimburse costs ordered to be paid out of the pension scheme in such circumstances.

Retirement cover

During a pension scheme's membership of **OPDU**, all retired trustees and administrators are insured. If a pension scheme leaves membership, retired trustees and retired named administrators automatically qualify for personal insurance cover for 12 years. This provides individuals with valuable peace of mind in their retirement when they no longer have any say in whether their pension scheme should purchase insurance cover.

Services

The Advisory Service

Provides trustees and administrators with general guidance and advice on matters affecting the day-to-day administration of the pension scheme. It aims to facilitate good governance. The confidential advice line is staffed by lawyers and provides access to The Advisory Panel Experts where appropriate.

The Advisory Service is complementary to the services provided by members' existing professional advisors.

The Claims Service

Provides the best possible claims handling service through a team of in-house barristers who deal with claims in a sympathetic and professional manner under claims authority from the insurer. They are experienced in managing complex, sensitive disputes with due regard to the adverse publicity that litigation can attract.

Other facilities

OPDU can provide access to a number of other insurance facilities, for example: winding-up insurance; crime and fidelity insurance; cover for trustees following mergers and protection against costs and the risks inherent in pursuing claims for damages against third parties such as fund managers and other service providers. If you have novel insurance requirements, we can work with you to seek to develop a policy to meet your needs.

For further information
enquiries@opdu.com
www.opdu.com

Some Key Issues for Trustees

With a new Coalition Government, an active Regulator and potential new EU rules, 2011 will be a busy year for trustees. Here are just a few of the current issues:

Pensions Bill (1) (RPI v CPI)

The Department for Work and Pensions consultation paper contains key proposals. These include no direct override of the provisions of a scheme's own rules, no enabling modification power where RPI is specified in the rules and, generally, no CPI underpin for schemes providing RPI increases.

Pensions Bill (2) (Surplus to Employers)

The Bill confirms that a resolution is needed only where the trustees of a defined benefit scheme wish to be able to make payments to an employer where there is a surplus in an ongoing scheme. It extends the transitional period to pass a resolution until 6 April 2016.

Pensions Bill (3) (State Pension Age)

This confirms that State Pension Age for men and women will be equalised at 65 from 2018 and that State Pension Age will increase to 66 from 2020.

Pensions Bill (4) (Default Retirement Age)

Similarly, it has been confirmed that, subject to a transitional period from April 2011, the Default Retirement Age will be abolished in October 2011. It will be interesting to see how this and the change in State Pension Age affects working lifetimes and the age from which scheme benefits are taken.

Restriction on Pensions Tax Relief

From the 2011/12 tax year, the amount of pension contributions or pension earned that will qualify for full tax relief reduces from £255,000 to £50,000. Trustees need to be familiar with their Scheme's Pension Input Period and the potential implications for members and scheme administration. From 6 April 2012, the maximum amount of tax approved pension savings will reduce from £1.8 million to £1.5 million.

Administration Campaign

The Pensions Regulator has launched a campaign highlighting the importance of administration in enabling good outcomes from pensions saving. This builds on last year's campaign for record keeping and data, and aims to increase awareness and understanding among trustees and administrators of their accountabilities and responsibilities for achieving high standards of administration. Further guidance will follow.

DC Schemes (1) (Good Member Outcomes)

The Pension Regulator's discussion paper invites views on how it may be possible to raise standards in defined contribution pension provision and therefore engender greater confidence in pension saving. Six key elements are identified, together with a number of areas where it believes there are challenges to be met. These include effective and efficient administration, cost and fair value, appropriate decisions in converting private pension savings into a retirement income, and accountability for decision making in members' interests.

DC Schemes (2) (Investment Governance Principles)

The Investment Governance Group (IGG), has published its recommendations for good investment practices in DC schemes. The six principles have been designed to encourage better governance amongst all types of DC schemes. The Group is chaired by Bill Galvin, the recently appointed Chief Executive of the Pensions Regulator.

DC Schemes (3) (Annuities)

The effective requirement to use a DC pension fund to buy an annuity from age 75 will be removed, with restrictions, from April 2011.

DC Schemes (4) (Annuities Part 2)

A forthcoming European Court of Justice ruling could ban the use of different annuity rates for men and women. If this happens, male annuity incomes are likely to go down whilst females annuity incomes could go up.

Not Forgetting...

NEST and auto-enrolment, changes to PPF levies, the Public Service Pensions Commission report, the treatment of Guaranteed Minimum Pensions, Solvency II and extension of time limits for contribution notices and financial support directions. These are just some of the other issues.

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.

Advisory Service Forum
Court Decisions Summary 2010

Sue Tye, *Baker & McKenzie LLP*

The Courts have seen in the last year a range of interesting pension cases. In this article we look at a number of judgments, together with their potential impact on pension scheme practice and procedure.

The decisions fall under a number of headings:

- amending schemes and equalisation
- ranking of financial support directions issued by the Pensions Regulator
- benefit entitlements and estoppel
- employer debt and scheme funding; and
- the validity of compromise agreements.

Amending Schemes and Eqalisation: Independent Trustee Services Ltd & Anor v Knell[1]

What happened?

This case concerned steps taken to equalise pension benefits payable from the Hobourn Group Pension Scheme in the early 1990s, following the *Barber* decision on 17 May 1990.

The scheme was governed by rules which defined Normal Retiring Date ("NRD") as age 65 for men and 60 for women. The amendment power required amendments to the rules to be made by deed. In April 1992, the trustees and principal employer wrote to members announcing an intention to increase NRD to age 65 from 1 July 1992 for existing members and from 1 March 1992 for new hires. A newsletter in May 1992 stated that the trustees would be increasing NRD to 65 for all female members from 1 July 1992. The rules were subsequently amended by deed dated 25 November 1993, amending the definition of NRD with effect from 1 July 1992.

The parties agreed that NRD was effectively and clearly amended in December 1995.

The issues

There were two key issues:

- Did the announcement and the newsletter change NRD?
- What was the effect of the 1993 Deed?

The scheme's power of amendment provided for the principal employer and the trustees to amend the rules by deed.

The 1993 Deed amended the definition of NRD as follows:

(a) in relation to a female Member before 1 July 1992, her 60th birthday, and

(b) in relation to any other Member his or her 65th birthday."

Did this mean that:

- all female members at 1 July 1992 retained NRD 60 for ***all*** pensionable service? If so, given the effect of the *Barber* judgment, the Barber window for men would run from 17th May 1990 to December 1995 when NRDs were undisputedly equalised (the argument by Mr Knell, a member); or
- NRD 60 was retained for all female members at 1 July 1992 but ***only*** for pensionable service to 1 July 1992? In that case, the Barber window for men would only run from 17 May 1990 to 1 July 1992 (the argument run by the trustees).

What the Court said

The Court held that any amendments to the definition of NRD must be made by deed in accordance with the amendment power, and that the definition of NRD was therefore only amended by the 1993 deed.

The judge deemed the announcement and newsletter to be of no effect[2] , being "*statements of subjective intent on the part of the Scheme Trustees*".[3]

The Court also considered whether a rule requiring the trustees to grant discretionary benefits at the request of the principal employer could be applied to effect the changes specified in the 1992 announcement and newsletter so as to give retrospective effect to the equalisation measures (it was common ground before the Court that the 1993 Deed did not have retrospective effect). Citing *Bestrustees v Stuart*[4] the judge held that:

"*The plain wording and the plain requirements of the Trust Deed are that alterations to the Rules are to be made by the principal company with the consent of the Trustees by Deed. A change in the*

[1][2010] EWHC 650(Ch). [2]Paragraph 28. [3]Paragraph 12. [4]OPLR 341 paragraph 34. [5]Paragraphs 32, 33 and 34 of the judgment.

NRD is a change in the Rules…. Rule 3(F) plainly has no application to what was sought to be done in relation to the NRD, and the item in Pension News was wholly ineffective to change the NRD for anybody."[5]

With regard to new joiners, it was also held that the 1992 announcement "*was wholly ineffective to achieve that objective.*" [6]

Turning to the 1993 Deed, the judge determined that with effect from 25 November 1993 (the date of the Deed):
"*the definition of NRD means (a) in relation to the Pensionable Service of a female Member before 1 July 1992, her 60th birthday, and (b) in relation to any other Member or Service his or her 65th birthday*".[7]

This conclusion was reached by looking at the rules as a whole, and in particular amendments made by the 1993 Deed to other provisions, especially the early retirement provisions. The judge determined that those amendments pointed towards the split service approach rather than creating a pure NRD 60 cohort of female members. The judge did, however, note difficulties created by the drafting in deriving "*an entirely coherent scheme.*"[8]

Implications for other schemes

The case is another example of the Courts rejecting arguments that a deed amending NRD could have retrospective effect so as to reflect the contents of previous member announcements. In particular, Norris J was clear that, even though member communications issued to new hires from 1 March 1992 referred to NRD 65, these alone were ineffective to increase NRD for new hires in the absence of a rule amendment.

The case also demonstrates the difficulty that the Courts have in reaching a conclusion where the drafting of the rules does not present a "coherent scheme", striving to find a practical and purposive resolution

Financial Support Directions: The Nortel/Lehman Brothers High Court Decision[9]

What happened?

This case concerns the status of a financial support direction ("FSD") issued against an insolvent company by the Pensions Regulator. The judgment has potentially far reaching consequences for companies against which an FSD is issued and therefore for groups of companies within which a defined benefit scheme operates. However, at time of writing, we understand that it is subject to appeal.

By way of recap, an FSD requires reasonable financial support to be put in place for a pension scheme by a company. The Regulator must be satisfied that:

- the scheme employer is either a service company or is insufficiently resourced (i.e. that it does not have enough resources to meet 50% of the scheme's estimated section 75 debt); and
- the target of the FSD is connected to or associated with the scheme's employer.

The Regulator had determined that it would be reasonable to issue FSDs against companies in both the Nortel Group and, separately, the Lehman Brothers Group in relation to their respective defined benefits schemes.

Administrators for the Nortel and Lehman Brothers groups sought directions from the Court about the status of an FSD issued against an insolvent company.

The issue

The key issue was what is the effect of an FSD issued against a company ***after*** the target goes into administration or liquidation?
Four theories were considered:
(a) the cost of compliance with the FSD is an expense of the administration or liquidation;
(b) the cost of compliance is a provable debt within the administration or liquidation;
(c) the Court should direct compliance under the principle in ex parte *James*[10] ; or
(d) the FSD creates a non provable claim against the target, payable out of any surplus after payment in full of all unsecured creditors.

The Regulator, scheme trustees and the Pension Protection Fund supported theory ***(a)*** (expense) with a fall back of theory ***(b)*** (provable debt). Two of the Lehman companies supported as a further fall-back theory ***(c)*** (ex parte James). The Administrators supported theory ***(d)*** (non provable debt) but by implication preferred theory ***(b)*** over ***(a)*** if it came to it.

Why did it matter? Because the categorisation of a liability in insolvency proceedings has a significant effect on, not only the extent to which that liability is paid, but also the extent to which all other claims in the insolvency are met.

One of the primary concerns of the Administrators was that if an FSD were an expense liability, this would damage the objectives of the rescue culture of insolvency practice. The following submissions were made:

- pending a decision of the Regulator on whether to approve a proposed financial support arrangement or the issue of a contribution notice (CN), the administrator would be faced with an unknown contingent liability with "super priority" of a "potentially crippling amount";

[6]Paragraph 35. [7]Paragraph 36. [8]Paragraph 27. [9]Bloom and others v Pensions Regulator (Nortel, Re) [2010] EWHC 3010 (Ch) (10 December 2010) [10][1874] 9 Ch App at 609 - which is a principle that permits the Court to give directions where an officer of the Court would otherwise be required to act dishonourably.

- that would disable the administrator from an informed judgment of alternative courses of action in administration which in turn, would disable him from the beneficial management of the company's business and affairs;
- administrators would not know whether any dividend would be payable to unsecured creditors or be able to discharge the administration expenses in full, not know whether business should continue to be traded and be reluctant to take office because their own expenses would not necessarily be paid.

Examples were given of the Nortel potential maximum exposure of £2.1 billion (being the full estimated section 75 debt) which, in theory, could be the amount required under a FSD and/or any subsequent CN. The submissions concluded that the issue effectively could put any administration on hold.

The Regulator responded that:

- a target's liability under an FSD was no more than to provide ***reasonable*** financial support having regard to the circumstances, including its financial position. It was alarmist to suggest that the financial consequences of the Nortel FSD stood in the region of £2.1 billion, representing the full section 75 debt; and
- the Companies Court can intervene, on application by the administrator, to prevent uncertainty in administration by altering the priority of any expenses to ensure that expenses needing to be incurred in implementing a successful business rescue were not put at risk.

Essentially, the issue came down to one of statutory interpretation: which of theories ***(a)*** to ***(b)*** did Parliament intend to apply as the financial consequence of an FSD being imposed in these circumstances?

What the Court said

After an extensive review and analysis of insolvency legislation and the Pensions Act 2004, the Court concluded that:

- the FSD regime applies to target companies both in and not in an insolvency process;
- the Pensions Act 2004 does not provide for priority of an FSD or CN in the insolvency process. This was contrasted with employer debt section 75 of the Pensions Act 1995 which, because of the drafting of the legislation,[11] is a provable but non-preferential debt in any insolvency process.
- an FSD issued ***after*** the commen cement of an insolvency process cannot give rise to provable debt in that process;
- it will rank as an expense of the administration or liquidation (as appropriate);
- if an FSD is issued to a company while in administration and a CN is issued ***after*** that and ***before*** liquidation, the CN is a provabl debt in the liquidation.

The judge was clearly reluctant in reaching this conclusion, noting the oddity that whilst an FSD would be given "super priority" if issued to a target company in an insolvency process, if issued ***before*** the start of its insolvency process, it would be a provable debt but not have the priority of an expense. It was stated that a "less unsatisfactory resolution" would be for legislation to provide for an FSD or CN to be a provable debt in an insolvency. This would then rank pari passu in the distribution of the assets, after payment of expenses and preferential creditors and secured creditors (i.e. in the same way as an FSD issued before insolvency proceedings have started) and would avoid damage to the rescue culture.

The judge concluded that, whilst the FSD regime does have a potentially adverse impact on the rescue culture, this could largely be kept to a minimum by the making of prospective cost orders by the Companies Court. This point did not force the Court to conclude that an FSD liability should fall into a black hole and be neither an expense nor a provable debt.

Implications for other schemes

Pending the outcome of the appeal, the decision is of concern to insolvency practitioners in that it may hinder restructuring strategies. Whether the ability of the Companies Court to issue prospective costs orders will assist has yet to be seen. As important is how the Regulator chooses to exercise its powers in the light of this judgment.

Perhaps more fundamental are the concerns that this judgment may create for those who finance businesses which operate within a group where there is a defined benefit scheme. The outcome of the appeal or a change in the legislation are eagerly awaited.

Estoppel: Catchpole v Trustee of the Alitalia Airlines Pension Scheme[12]

The principle of estoppel in a pensions context has been considered by the Court in two recent cases, one where it was upheld, and the other where it was not.

What happened?

In *Catchpole v Alitalia Airlines*, Mr Catchpole, whose deceased partner was a member of the scheme, appealed against a ruling by the Pensions Ombudsman that he was not entitled to a spouse's pension. Mr

[11] Section 75(6A)(a) and (6C)(a) and section 121 of the Pensions Act 2004.

Catchpole and his partner had decided not to marry after his partner had asked the scheme secretary whether the claimant was entitled to a spouse's pension under the scheme and was incorrectly told that he was. In fact, under the scheme rules, a spouse's pension was only payable to someone legally married to the member.

Mr Catchpole's partner died and no pension was payable. Mr Catchpole complained to the Pensions Ombudsman. The Ombudsman decided that the representation was maladministration on the part of the trustees but found that, on the balance of probabilities, the Mr Catchpole and his partner would not have married to secure an entitlement to a spouse's pension.

Mr Catchpole appealed.

The issue

The issue was whether or not the trustees were estopped from denying Mr Catchpole a spouse's pension because he and his partner had relied, by not getting married, on the representation by the trustees.

The Court had to consider whether the factual evidence supported the decision made by the Ombudsman. The Court noted that it may only interfere with a determination of fact if it was one which the evidence did not support.

What the Court said

The Court decided that the trustees were estopped from denying Mr Catchpole a spouse's pension and that he should receive that benefit from the scheme.

Warren J found that the trustees had made a clear representation by which they were bound, that the spouse's pension should be paid, that contrary to the Ombudsman's finding, the couple would have married if they had known the true position under the scheme rules and that Mr Catchpole would suffer detriment if the trustees were not bound by their representation.

The Court was assisted in reaching this conclusion by the fact that the couple could, if they had been given the correct information, have married without further recourse to the trustees and the benefit would then have been payable as of right to Mr Catchpole.

Implications for other schemes

This is the first successful estoppel claim of a pensions nature for over twenty years[13], that time scale reinforcing the difficulties of establishing such a claim. It provides an extensive analysis of what constitutes estoppel and so is of value in considering other claims.

The judge also considered the difficulties posed by a successful estoppel claim against a pension scheme, resulting in a call on the scheme assets which is not authorised under the scheme rules and which could have an adverse effect on the other beneficiaries of the scheme. However, he decided that the estoppel must bind the trustees and their successors and so also the members and the other beneficiaries.

Estoppel: Cubic & Ors v Weale[14]

What happened?

Mr Weale transferred his past service benefits under the BTR pension scheme to the Cubic scheme in 1997 when his employer was sold to Cubic. Mr Weale had become an active member of the Cubic scheme, agreeing to be bound by its rules.

He applied for an early retirement pension from the Cubic scheme at age 60. He understood that he was entitled to an unreduced pension at 60. The trustees agreed to pay a reduced pension at 60. Mr Weale complained to the Pensions Ombudsman. He claimed that under the BTR scheme he was able to retire at age 60 with an unreduced pension and that statements had been made at the time of the sale of his employer to Cubic and on joining the Cubic scheme that no reduction would be applied on retirement between 60 and 65.

The Ombudsman determined in Mr Weale's favour, basing his decision on one letter in particular which stated that on transfer Mr Weale would be entitled to benefits *"equivalent overall to those you would have received from the BTR Scheme in respect of service up to 5 April 1997"*.

A number of other documents had been issued to Mr Weale in relation to the transfer and his scheme membership, including an announcement, form of election to transfer and summary of benefits.

The Ombudsman directed that the pension representing the transferred in benefits should be paid unreduced at 60 and that a payment of £500 be made to Mr Weale as compensation for distress and inconvenience.

Cubic appealed.

The issue

Cubic contended that the Ombudsman's decision was wrong in law because under the Cubic scheme rules there was a discretion to permit Mr Weale to retire early and, if granted, whether that pension should be reduced.

What the Court said

The Court determined that the Ombudsman's decision was insupportable in law and should be set aside.

[12] [2010] EWHC 1809 (Ch) [13] the last and only other being the Icarus case Icarus (Hertford) Ltd v Driscoll [1990] 1 PLR [14] [2010] EWHC 3231 (Ch)

The letter should not have been looked at in isolation and when it was read with a summary of benefits statement, an announcement and a form of election also issued to Mr Weale at the same time, there was no clear and unambiguous representation made that Mr Weale would be able to take an unreduced pension at 60 in the Cubic scheme. The announcement made it clear that the scheme rules would establish the member's benefit, and the other documents provided noted that early retirement would require trustee and company consent. The conditions for estoppel were not met and Mr Weale's rights in relation to early retirement pension were subject to the provisions in the Cubic scheme rules.

Implications for other schemes

This case reiterates the difficulty of relying on estoppel in relation to pension schemes and contrasts with the finding in the *Catchpole* case.

It shows the attention the Court pays to each document put forward in evidence and the weight given to a statement that benefit entitlements will be set out in full in the scheme's rules, reinforcing the value of this type of wording in all communications with members.

Scheme Funding: The Pilots' Case[15]

This High Court case addresses a number of key issues, including the application of the statutory employer debt regime, and the interaction of the scheme specific funding regime with the scheme rules.

What happened?

The claimant was the trustee of the Pilots' National Pension Fund (the "PNPF"), an industry-wide scheme for UK marine pilots.

There are 53 "participating bodies" in the PNPF. Most of them are Competent Harbour Authorities ("CHAs"), which are, essentially, port authorities. In order to act as a marine pilot, a person must be authorised by the CHA in his area. Some of the CHAs employ all of their pilots ("ECHAs"), while others do not employ any of their pilots ("SCHAs"). A handful of CHAs have both employed pilots and authorised self-employed pilots.

The PNPF had a deficit on the buy-out basis as at 31 March 2009 of just over £285 million. The total proportion of the PNPF's liabilities that were referable to the pensionable service of self-employed members was estimated to be 87%.

The scheme rules in their original form contained narrow ongoing contribution rules. These required ECHAs to pay contributions equal to 1.5 times the contributions of their active members, while SCHAs were required only to collect the contributions of their active members and remit them to the trustee. There was no specific provision for meeting deficits.

In 2005 and 2009, the trustee introduced two further specific contribution rules, which gave the trustee the power to demand additional contributions in certain circumstances.

The issues

The trustee sought guidance from the High Court to clarify how, if at all, it could go about repairing the deficit. In particular, the trustee sought guidance on which entities could be made liable to contribute to the PNPF.

The trustee requested a decision on 11 questions, subdivided into 39 issues. These divide into four topics:

- the scope of the trustee's ability to amend the rules so as to broaden the trustee's powers to demand contributions;
- the validity of the two contribution rules that the trustee had introduced in order to deal with specific situations;
- the application of the statutory employer debt regime under section 75 of the Pensions Act 1995; and
- the extent to which the scheme specific funding regime gives the trustee wider or narrower powers to demand contributions than those contained in the scheme rules.

What the Court said

The High Court reached the following decisions on the key points:

- The scope of the amendment power was sufficiently wide to allow the trustee to amend the scheme rules to require both ECHAs and SCHAs to make additional contributions, whether or not the CHA currently employs/authorises pilots accruing benefits. The power was not limited to requiring CHAs to meet that part of the deficit attributable to the pensionable service of members who are or have been employed/authorised by the CHA in question or which accrued while the members were (or are) employed/authorised by the CHA in question.
- The new contribution rules were validly introduced and within the scope of the amendment power.
- Neither SCHAs nor self-employed pilots are "employers" for either employer debt or scheme specific funding purposes but may nevertheless be subjected to funding requirements under the scheme rules.
- The assets and liabilities to be taken into account when calculating employer debts are all of the assets and liabilities of the scheme, and not only those attributable to employment with ECHAs.
- Ceasing to employ its last active member prior to 6 April 2008 did

[15] *PNPF Trust Company Ltd v Taylor and others*

not trigger an employer debt if the ECHA in question continued to employ at least one person eligible to become a member, whether or not joining the scheme would require the consent of the trustee. Departing from the High Court decision in *Cemex UK Marine Limited v MNOPF Trustees Limited*, Warren J held that it was not enough to prevent an employer debt being triggered that the ECHA in question continued to employ at least one person who was either a deferred member or a pensioner member (unless they were eligible to rejoin the scheme). Nor was it enough that the ECHA might, in the future, employ a person eligible to become a member.

- The same eligible employee test applies for the purposes of determining when an employer ceases to be an "employer" for scheme specific funding purposes.
- Trustees are not restricted by limits in scheme rules when proposing a schedule of contributions. In line with the view he expressed in *British Vita*, Warren J considered that the scheme specific funding regime supplements the existing scheme contribution rule by creating a statutory obligation to pay any excess contribution where the scheme contribution rule is inadequate to meet the statutory funding objective.
- The coming into force of a schedule of contributions under the scheme specific funding regime would not prevent the trustee from relying on its contribution powers under the scheme rules in respect of persons who do not constitute "employers" for statutory purposes (such as SCHAs).

Warren J did not answer the question of whether the trustee is entitled to rely on a contribution rule permitting or requiring contributions in excess of the amount due under a schedule of contributions from persons obliged to contribute under such a schedule (in this case, ECHAs). However, he did comment that there is *"a great deal to be said . . . in favour of the conclusion that the trustees can rely on the rules of the scheme to require payment of a larger contribution than has been shown in the schedule of contributions"*.

Implications for other schemes

The key consequences of the decision in relation to scheme funding are as follows:

- If an employer ceased to employ its last active member prior to 6 April 2008, this did not trigger a statutory employer debt if the employer continued to employ at least one person eligible to become a member, whether with or without trustee consent. Previous debts, debt calculations and liability may therefore need to be revisited.
- Trustees are not restricted by limits in scheme rules when proposing a schedule of contributions.
- The coming into force of a schedule of contributions does not prevent trustees from relying on their contribution powers under scheme rules in respect of entities which do not constitute "employers" for statutory purposes (i.e. employer debt and scheme specific funding purposes).
- Trustees may be able to rely on a contribution rule permitting or requiring contributions in excess of the amount due under a schedule of contributions from persons obliged to contribute under such a schedule.

Scheme Funding and Deficit Repair: The Navy Ratings' Case[16]

This case involved a deficit repair regime, introduced in 2001, which allocated the entire legal liability for repair of the scheme's deficit to a minority of the employers participating in the scheme.

What happened?

The case concerned the Merchant Navy Ratings Pension Fund, a non-sectionalised industry-wide defined benefit occupational pension scheme established for the benefit of ratings of the British Merchant Navy. Some 240 employers of ratings have participated in the scheme.

The scheme has, since the late 1990s, been in deficit. An actuarial valuation conducted as at 31 March 2008 revealed that the scheme had a funding deficit measured on the buy-out basis of £370 million (representing a funding level of 63%).

A regime was introduced in 2001 to repair the deficit in the scheme. This regime allocated the entire legal liability for repair of the deficit on a minority of the employers participating in the scheme. Stena Line Limited brought a claim on behalf of those employers to determine whether the trustee had the power to amend the 2001 regime so as to impose deficit repair contribution obligations on the remaining participating employers (the "Specified Employers").

The Specified Employers contended that the trustee could not make such an amendment on the basis that the 2001 regime irrevocably released the Specified Employers from any further contractual obligations to make deficit repair contributions. The Specified Employers put their case, firstly, as a matter of interpretation of the relevant rules and alternatively on the basis of estoppel by convention.

Although the trustee adopted a broadly neutral stance in the litigation, it indicated that if the Court concluded that it had the requisite power to amend the scheme rules, it would be minded to exercise it on the basis that any broadening of the pool of contributors to the deficit

[16] *Stena Line Limited v Merchant Navy Rating Pension Fund Trustees Limited*, 27 July 2010

would be likely to be beneficial to the scheme's members.

The issues

The key issue was whether the trustee had the power to amend the 2001 regime so as to impose deficit repair contribution obligations on the other participating employers.

Stena contended that the trustee could alter the scheme to impose contribution obligations on the Specified Employers.

The Specified Employers contended that the trustee lost the power to make the disputed amendment due to the introduction of the 2001 regime. They argued that there was a consensus among all participating employers that once the 2001 regime was implemented the Specified Employers were irrevocably released from any further legal obligation to make deficit repair contributions to the scheme (except for certain statutory obligations which had already been discharged). The Specified Employers put their case, firstly, as a matter of interpretation of the rules and alternatively on the basis of estoppel by convention.

The Specified Employers argued that under the previous rules all participating employers had a right to object to any proposed deficit repair regime under a provision that allowed winding up if no agreement was reached on measures for addressing a deficit. This was removed from the rules as part of the 2001 regime. The Specified Employers would not have assented to its removal unless they were being permanently released from any further contractual deficit repair obligation. The permanent release from liability to make deficit repair contributions was effectively a quid pro quo for the Specified Employers' assent to the removal of that provision.

They also argued that there was a convention that from the implementation of the 2001 regime they were irrevocably released from making any further non-statutory deficit contributions and that this estopped the trustee from amending the scheme rules so that the Specified Employers could be required to make such contributions. All of the Specified Employers had relied on this convention to their detriment in not objecting to the introduction of the 2001 regime by exercising their rights under the rules to wind up the scheme. Further, for some Specified Employers, the detrimentally reliant conduct was also alleged to consist of the making of the voluntary payments on the assumption that those employers would not be subject to any further non-statutory deficit contributions.

What the Court said

The Court held that the 2001 regime was not irrevocable and that the trustee had the power to amend the scheme so as to impose deficit contribution obligations on employers to repair any funding deficit attributable to pensionable service of members whilst in the service of that employer.

Briggs J held that the 2001 regime created a deficit repair regime which imposed no contractual obligations on the Specified Employers. Therefore, for as long as it endured unamended, the Specified Employers were not subject to any contractual deficit repair liability.

However, the finding that the 2001 regime was ***not*** irrevocable and that the trustee retained its full power of amendment meant that, in principle, this power remained broad enough to permit an amendment of the scheme which would require Specified Employers to contribute to the scheme by reference to liabilities in the scheme attributable to pensionable service of members whilst in the service of that employer.

The Court held that powers to amend pension schemes should be given a broad interpretation consistent with the need to preserve their utility over a long period of unpredictable future events. The Court also considered the scheme's power of amendment together with other scheme provisions and held that the provision relating to deficiency expressly recognised that there was scope for the 2001 regime to be amended where it failed to achieve its objective, or if a new deficit arose which required different measures to be taken.

On the estoppel point, Briggs J held that the estoppel case failed on the facts to assist any of the Specified Employers. There was insufficient evidence to suggest that the trustee had said or done anything in relation to the participating employers sufficient to create a convention that irrevocably released the Specified Employers from making any future non-statutory deficit contributions.

In relation to the Specified Employers' arguments around rights under the previous rules, Briggs J held that this was based on the assumption that the Specified Employers could have prevented the introduction of the 2001 regime by an exercise of their supposed rights under those rules. However, Briggs J concluded that no individual Specified Employer had any such right under those rules.

Implications for other schemes

This case provides insight into how scheme rules will be interpreted by the Court, in particular in relation to the power of trustees to make employers liable to contribute to schemes. The judgment emphasises that powers to amend pension schemes should be given a broad interpretation consistent with the need to preserve their utility over a long period of unpredictable future events.

The case also acts as a reminder for trustees to be careful in communicating with employers so as not to create a "common assumption" between them in relation to which an estoppel could apply to bring to an end the employer's liability to the scheme.

Validity of Compromise Agreements: The IMG Case[17]

What happened?

This point was considered by the Court of Appeal as a preliminary issue to a potential settlement in the ongoing litigation between the company and representative of the members over a failed attempt in 1992 to convert the scheme's final salary benefits to money purchase benefits.

In the IMG case, the High Court effectively invalidated the company's attempt in 1992 to convert members' accrued final salary rights to money purchase rights because this breached a protective provision in the scheme's amendment power. This meant that the converted money purchase pots were subject to a final salary underpin with continued salary linkage.

The judge also held that individual waivers of any final salary rights that some members had signed some years after the purported conversion were unenforceable under section 91 of the Pensions Act 1995.

Section 91 provides, subject to certain exceptions, that:
"*(1)…where a person is entitled to a pension under an occupational pension scheme or has a right to a future pension under such a scheme – (a) The entitlement or right cannot be assigned, commuted or surrendered*".

The High Court decided in the IMG case that the compromise agreements were unenforceable under section 91 because they constituted "surrenders" or agreements to effect a surrender of pension entitlements or rights. Section 91 applied even where there was a bona fide dispute about the existence of the entitlement or right in question.

This caused substantial concern within the industry and calls to amend the legislation on the basis that genuine settlements of disputed rights could not now be achieved by compromise agreement, effectively forcing members and trustees into expensive litigation to argue disputed rights to a conclusion, even where both parties might prefer to settle.

It also raised a question mark over the validity of past settlements, even those approved by the Court.

The issue

To assist the parties to the IMG case in their negotiations for a compromise, the Court of Appeal was asked whether section 91 prevented the parties from entering into a court approved settlement: would a compromise involve an unenforceable "surrender" of pension entitlements or rights under section 91 by members of the pension scheme?

What the Court said

The Court of Appeal determined in an initial short ex tempore decision that section 91: "*is not an obstacle to reaching a binding bona fide compromise of a bone fide dispute*".

The Court's subsequent full judgment determined that the parties are not prevented by section 91 from *"making, or the court from approving or enforcing, a bona fide compromise of disputed or doubtful entitlements or rights under an occupational pension scheme."*[18] Accordingly, the Court rules that section 91 would not render unenforceable a court approved compromise of the matter.[19]

- Section 91 determined that the section is directed to cases of the "deliberate giving up of an actual existing entitlement or an actual existing right".[20] The effect of the compromise is that the existence of the right or entitlement will never be known and so section 91 cannot come into play.

Implications for other schemes, employers, trustees and members

This is a decision of wide importance and removes the uncertainty and concerns that the High Court case raised.

It should, however, be noted that the decision centres on the compromise of claims to entitlement or rights that are doubtful or disputed. Undisputed, established rights and entitlements remain subject to section 91 and are inalienable. Careful consideration should therefore be given to any proposal to surrender pension rights or entitlements and how properly to document settlements of pension disputes.

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[17]International Management Group (UK) Ltd v German and another [2010] EWCA Civ 1349. [18]Paragraph 2. [19]Paragraph 43. [20]Paragraph 27.

Advisory Service Forum
Ombudsman Determinations

Mark Grant, *Partner, CMS Cameron McKenna LLP*

McLeish (74426/2)
Should administrator exclude or caveat "unattractive" options?

On leaving service in 1995 the member was given the option of either a refund of contributions, a deferred pension, or a transfer-out. The member chose the deferred pension. However, because the member's own contributions were so close to the actuarial value of his GMP, there was in fact no identifiable advantage in taking a GMP from the scheme. Had he taken a refund of contributions, he would still have received almost exactly the same state pension as the pension he would have received from the scheme had he not taken a refund in addition.

The administrator said that there was no legislation saying that they should provide advice as to which option would be more appropriate. However, the Ombudsman held that the provision of the deferred pension option to this member was, "without hindsight", worthless. It should either have been excluded, or the member should have been given sufficient information to make the decision. The Ombudsman acknowledged that the circumstances were unusual, but the member *"would not have been able to work [it] out for himself"* and the administrator should *"have identified on behalf of the then trustees that in such circumstances the deferred pension option was unattractive."* Had the member been given correct information, he would undoubtedly have opted for the refund.

Kenny (28034/5)
Member receiving overpayments should have spotted "something was amiss"

In October 2000, the member received a (correct) estimate of benefits for retirement, quoting an annual pension of just over £11,000. When the pension began, from August 2001, an annual equivalent of over £25,000 was brought into payment by mistake. The error was discovered six years later and the member was asked for proposals for repayment. The member said that he thought a previous transfer value might have contributed to the difference in pension, and provided details of money he had spent since his retirement, in reliance on receipt of the higher amount.

The Ombudsman noted that that if it could be shown that a member had spent such an overpayment on something which he would not otherwise have done, and the money could not now be recovered, a "change of position" defence might succeed. However, an essential element of that defence was that the individual must have changed his position in good faith. The Ombudsman said that he was happy to accept that the member *"was not* ***"a pensions expert"*** *and that perhaps he was not the most practical of men"*. Nevertheless, the discrepancy was so great that the member should have been aware that something was amiss. He was not therefore entitled to rely on the change of position defence.

Lane (75903/1)
"Extreme circumstances" justified higher distress award

The member's benefit statement described her prospective pension entitlement as £5,000 p.a. In fact, the correct figure was £2,000. The employer failed to chase up an e-mail it had sent to the administrator asking for further information about the benefit calculation, and, even on becoming aware of the correct figure, failed to pass this on to the member when it could have done so (and when it might still have been possible to take some remedial action). Due to the "considerable stress and inconvenience" caused (which included the member being without any income at all for a period), the employer should pay her some £1,000 in respect of its maladministration: while the Ombudsman accepted that *"[a]wards of compensation are usually modest", this figure reflected "the unusual and extreme circumstances".*

However, in respect of the member's claim to receive the higher pension originally promised, the Ombudsman noted that she would need to establish that she relied, to her detriment, on the information provided by the employer. The test was to place her in the position she would have been in had the maladministration not occurred. The Ombudsman held that she would not have made a different decision on retiring early had she known the correct position. This was particularly the case given that the retirement was made as a result of her ill-health and there was no realistic prospect that she would have been able to go back to her former, or any other, job.

Barnett (76149/1)

No redress against scheme that refused to accept transfer

The member tried to transfer his benefits from his old employer's scheme to his new employer's scheme. The new scheme trustees asked the old scheme trustees for an indemnity in relation to equalisation but instead of answering their questions the old trustees merely inserted "N/A" into the form (the relevant section of the transferring scheme had been fully equalised from its inception in 2001). The new scheme trustees refused to accept the transfer-in and the frustrated member brought a complaint against both sets of trustees.

The old scheme trustees explained that they had a policy, adopted on legal advice, of refusing to give any indemnities on transfer, although they accepted this was "cautious". The new scheme trustees confirmed that their policy was not to accept any transfer unless the former scheme indemnified them against the risk of a future equality ruling. The Ombudsman reiterated that while the Pension Schemes Act gives members a right to a cash equivalent it does not give them a right to transfer where the potential receiving scheme does not wish to accept it. Although the risk to either scheme of adopting a different policy might be "remote", he could not say that either scheme's position amounted to maladministration. He could not therefore interfere.

Atkinson (76135/2)

Trustees must assign natural meaning to terms in rules

The member was a pilot who went on long-term sick leave. His licence was subsequently withdrawn by the Civil Aviation Authority, who considered that he would not be able to fly again in the foreseeable future. Four years later, he requested ill-health early retirement. This required that *"in the opinion of the Principal Employer, the Member is (and will continue to be) incapable of carrying on his occupation"*. His application was declined on the basis that he was still well enough to carry out *"ground-based duties related to the occupation of a pilot"*. The member's employment was then terminated. Later, the member sought to challenge the decision to turn down his ill-health pension application.

The employer observed that "occupation" under the rules was a matter for it to determine, and said the rules had to be considered against the background of the employer's HR procedures and rules agreed with the British Airline Pilots Association, both of which recognised that the "occupation of a pilot" did not solely encompass flying.

The Ombudsman disagreed. The accepted approach to the use of the phrase "his occupation" in incapacity rules was to assign ordinary, everyday meaning to the words. The member's occupation was "pilot". *"I do not think it can reasonably be said that a pilot who can never fly again is still a pilot"*, the Ombudsman continued. *"It runs against the natural meaning of the word."* The only conclusion the employer could have reached was that the member left service due to the loss of flying licence caused by his incapacity. It had therefore misinterpreted the definition and this amounted to maladministration.

Roberts (74642/1)

Discretion as to employee's status was not absolute

The scheme's eligibility rule required an individual to be *"regarded by the Employer as being a permanent Employee"* and, later, not to be *"regarded by the Employer as a casual worker"*. The complainant had worked for the employer from 1997 without being admitted to the scheme. In 2006 an Employment Tribunal held that he had been a permanent (part-time) employee since 1997. He sought entry to the scheme. The employer said it continued to regard him as a casual worker.

The Ombudsman held that the employer could not simply decline to "regard" any employee as a permanent employee in the face of the facts. The onus was on the employer to show good reason why it did not regard him as a permanent employee. Similarly, their conclusion as to who was a casual worker had to be consistent with the facts. The Ombudsman directed that the complainant be given the option to secure backdated benefits in the scheme, subject to payment of appropriate contributions.

Sheppard (76726/2)

Backdated rule could still override member booklet

The booklet initially issued to members mentioned an unreduced early retirement pension payable on redundancy, but did not mention that employer consent was required. When the booklet was issued, the scheme was constituted only by an interim deed. The detailed scheme rules were finalised a year after the booklet was issued, including the reference to consent and backdating it to the outset of the scheme.

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The Deputy Ombudsman noted that case law established that rules generally prevailed over announcements, particularly where announcements specifically referred to overriding rules. She held that the fact that the deed was not available at the time the booklet was produced was insufficient to distinguish this case from that general legal principle. There could also be no contractual right based on the booklet information, because there was no certainty of terms: all relevant documents were expressed as summaries, rather than complete statements of benefits. Moreover, the employer and trustees were not "estopped" from relying on the change made by the later retrospective deed, as the member had not relied on any representation to his detriment. However, they were criticised for allowing the booklet to go unamended on this point for some six years after the deed had been executed, and an award was made of £250 for the distress and inconvenience caused.

Lawson (76103/1)

Death should not change decision to pay serious ill-health lump sum

The trustees approved the payment of a serious ill-health lump sum in respect of the member. However, unbeknown to them, the member had died five days earlier. On becoming aware of this, the trustees reviewed the decision and decided that in the light of the changed circumstances they would not pay out the serious ill-health lump sum after all. The executor complained to the Ombudsman.

The trustees said that one of their policy criteria for the award of such sums, that such commutation would benefit the member, was no longer satisfied. It was clearly relevant that the member had died: pension benefits were intended to provide continued financial support to a member, rather than to benefit their estate. The Ombudsman disagreed. The trustees' argument that the member would no longer benefit from commutation was "odd": given her shortened life expectancy, she was unlikely to have benefited much from it even while she was alive. There was nothing wrong with the decision reached to award the serious ill-health lump sum, and it should not have been revisited in the light of the member's death.

Winterstein (76288/1)

Simply following death benefit nomination was not enough

The member married in April 2007 but was diagnosed with cancer in November 2007. He died two months later, leaving a pregnant widow. His nomination form, completed in January 2006, had nominated his widow (who he was then living with) and his sister to receive 50% each of any lump sum death benefit. When the employer followed that nomination the widow complained. She felt that the member would have changed his nomination to give her 100%. His sister, however, said that he could have done so but chose not to: the original nomination had after all been made when he was expecting to marry.

The employer's reasoning referred to there being insufficient grounds to overturn the clearly expressed wish of the deceased. The Ombudsman felt that the employer had restricted itself to matters that it knew had changed since the nomination was made, and not looked closely enough into all the circumstances of the potential beneficiaries. It also failed to have regard to one relevant factor at all, namely that *"the nomination form was completed as one of the formalities of joining the Scheme. There was a different stimulus than at the times when* [the member's] *circumstances changed and the existence of the form needed to be considered in that light."* The decision was remitted for reconsideration.

Alexander (75915/1)

Provider liable for "positively driving" investment in inappropriate fund

The member was due to retire in October 2008. In June, he contacted the provider of his scheme's AVC arrangement about the transfer to it of his own free-standing AVCs. He was told this would not be possible but that instead he could pay his whole earnings as AVCs to maximise tax relief, and then be able to withdraw those contributions as a tax-free sum when he retired.

After the adviser persisted (the call was recorded, and the Ombudsman let it be known that he had listened to it in its entirety) the member agreed to make an immediate AVC application over the telephone. He described his attitude to risk as "medium" and was given the only medium risk fund available, a discretionary fund. Unfortunately, during the short period to the member's retirement, the value of that fund fell. The member complained that he had been improperly persuaded to contribute to it.

The Ombudsman held that a three-month investment in equities, bonds and property, made in order to get tax relief rather than seeking any investment upside, could simply not be regarded as "medium" risk.

"Medium risk" would have been an investment with negligible downside risk. The transaction had been both "proposed and positively driven" by the provider, giving them a responsibility to ensure the whole package was "rational and viable". The provider was directed to treat the member as if his AVCs had been invested in their cash fund instead.

Harris (27510/3)

Need to construe salary definition with care

While working on a specific project, the member was provided with a flat rate subsistence payment of £20 per day, intended to compensate for the out of pocket living expenses which would be incurred. He received total such payments of £4,920. "Earnings" which were pensionable under the rules were defined as total remuneration, including regular bonuses, incentive payments, other allowances or overtime. The member argued that his subsistence payment (which the employer had also described as a "subsistence allowance") was pensionable.

The Ombudsman said that while repayment of expenses would not generally form part of an employee's remuneration, the payment in question was not strictly a reimbursement. It was *"compensation for the fact that there would be expenses, without being exactly equivalent to them… the payment could easily have been described as an allowance of one sort or another"*. Nevertheless, the Rules only referred to allowances as a potential element of "remuneration". An allowance which was not earned, or provided as a reward, could not therefore fall within the definition of earnings. And although the member had been led to believe that the payments would be pensionable – and the employer should pay him £250 for the distress caused by his loss of expectation - in practice he would have worked on the project anyway.

Burman (74569/1)

Vague and non-specific statement could not amount to a "policy"

The member complained of maladministration by his former employer, which had refused his application for an augmentation. In considering its discretion to grant additional pensionable service, the employee was obliged under the relevant local government regulations to formulate a written statement of policy concerning the exercise of its discretionary powers, and to keep this under review. Late in the investigation, the employer produced that written statement namely that *"agreement will… be dependent on the merits of each case and will also be subject to cost implications."*

The Ombudsman said that a "policy" required more than a mere statement of what was, in effect, the general legal position in the absence of a policy. While a policy would not fetter the exercise of a decision-maker's discretion, it required the indication of a general approach and the considerations that would apply in exercising the discretion. The Ombudsman ordered the employer to reconsider its decision, using a properly formulated policy statement.

Earle (76674/1)

Trustees' delegation of death benefit decision was outside their powers

In 2000, the member completed a lump sum death benefit nomination form in favour of his two adult children. After that date, he met and later married the complainant, who said that both she and her own children were financially dependent on him. When the member died in 2006, the lump sum decision was delegated by the full trustee board to the secretary of trustees, under a delegation for cases with "a clear nomination form and no complications". The secretary awarded the lump sum to the adult children. His decision was later ratified by the full board.

The Ombudsman said that the existence of a widow, who the member had not even met when completing the nomination form, had to be considered a "complication" for the purposes of the delegation. Moreover, insufficient information had been collated about the widow or the financial position or degree of dependency of the competing beneficiaries. The matter should have gone to the full trustee board, and the secretary's decision had been ineffective. The case was remitted to the full board for reconsideration.

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A Guide to protecting Trustees, the Scheme,

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Trustees have an increasingly difficult job to do. The Pensions Act 2004 increased the legislative burden on trustees giving the Regulator wide ranging powers if schemes are not being managed appropriately and various new codes of practice have also been issued recently.

The issue of protecting trustees from liabilities has also become particularly topical following the various headlines reporting the liability of trustees including the cases involving the incorrect authorisation of unsecured loans to sponsoring employers. The Pensions Ombudsman's Office provides members with an easily accessible forum to pursue any disputes. In the recent ES Group Pension Scheme determination, the Pensions Ombudsman found several breaches and the trustees were personally liable to pay in excess of £500,000.

As can be seen, therefore, the responsibilities of a trustee are onerous which is also borne out by claims experience which demonstrates that errors can occur even in the best managed schemes particularly in the increasingly dominant environment of defined contribution schemes. Liability for breach of trust is a personal liability and a trustee is liable to both the scheme beneficiaries and to scheme creditors. Professional advice should be sought when appropriate and failure to do so may in itself be held to be a breach of trust. If trustees are uncertain as to how to exercise their powers, they can also apply to the court for directions *(see under: Court Applications)*. The risk is potentially greater after a winding up where there may be missing beneficiaries or other contingent liabilities and no assets. A trustee or trustee director is also potentially at risk of having to pay a civil fine for breach of pensions' legislation. Fines for individuals range up to £5,000 and for corporate trustees £50,000.

Limited Protection: Exoneration & Indemnity clauses

Many trustees will have the benefit of clauses within the trust deed and rules exonerating them from liability and in many instances, an indemnity may be given by the scheme or the sponsoring employer company. However, it is not always appreciated that such clauses are subject to statutory limits. For example, an exoneration or indemnity from the fund cannot operate for any breach of trust relating to investments and it is also prohibited for the scheme to indemnify trustees for civil fines and penalties. It should also be appreciated that an indemnity from the employer would be of no value upon an insolvency when the trustees are still having to manage the scheme.

Exoneration clauses are also subject to several other limitations including not affording protection from claims involving third parties and they will always be construed restrictively by the courts. The problem also with relying purely on exoneration and indemnity provisions is that they merely transfer any liability between the trustees, the beneficiaries and the employer. More importantly why should a pension member, who has a valid claim, be defeated by a legal technicality i.e. an exoneration clause. In today's environment, trustees do

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not usually wish to "hide" behind exoneration clauses when facing such claims.

Wider Protection: Insurance

In these circumstances, insurance is playing an increasingly important role in protecting trustees and pension scheme assets. It provides an external resource of protection and should stand in front of such indemnity and exoneration clauses. The purchase of a properly drafted and comprehensive insurance policy can be a cost-effective means of protecting members benefits, individual trustees, the sponsoring employer, pension managers and internal administrators from losses resulting from claims, be they well-founded or not.

If the decision is taken to adopt insurance, it is important to have a policy specifically designed to respond to the needs of trustees and other individuals involved in the management of pensions. This is highlighted by the potential conflicts of interest which commonly exist when a trustee is also a director of the sponsoring employer company with duties to the company and its shareholders. As a trustee, however, there is an overriding duty owed to the scheme beneficiaries which is paramount. Accordingly, it is not recommended that reliance be placed upon a Directors & Officers (D&O) policy of insurance as the cover will not be tailored to meet the specialised circumstances relating to pensions and potentially there will be competing calls on the policy. Furthermore, D&O policies will often contain an exclusion for any acts or omissions while acting as a trustee or administrator of the pension scheme.

However, it is also important to recognise the important differences which exist in the cover provided by different policy wordings which may appear very similar. When analysed in detail, the cover provided by some policies may be more limited than is at first apparent. An example would be if the cover is restricted to the personal liability of the trustees and there being no cover if there is an exoneration or indemnity clause.

Who should be protected

All those individuals involved in the trusteeship and administration of an occupational pension scheme should be covered by the insurance policy. The insurance should cover not only the trustees but the scheme itself so that a recovery can be made under the policy for the wrongful acts of the trustees that would otherwise be exonerated or indemnified. Although there may be technical difficulties over the legal persona of the pension scheme, it is sensible to verify that costs or liabilities, which fall to be paid out of the scheme's assets, can form claims on the insurance policy. The following should be included:

- Trustees – present or future
- Retired trustees
- Heirs, spouses and Estates
- Corporate Trustees
- Directors of Corporate Trustees
- The Pension Scheme
- Sponsoring Employers
- Employees
- Internal Advisers
- Internal Administrators
- Internal Dispute Managers

Therefore all parties should be entitled equally to the protection of the insurance so that it is not in the interest of any party to create a liability on the trustees purely to get the benefit of the insurance. This makes the cover much more valuable than pure legal liability insurance for the trustees only.

It is particularly important to ensure that the insurance policy provides for severability of cover for the individual interests so that even fraud by one of the insureds does not invalidate the cover for the other innocent insureds. In the event of a problem arising, individual trustees should be satisfied that the insurance policy will pay for their interests to be separately represented if appropriate and that they will not be overridden by the interests of the other parties covered by the policy. Some policies do not afford cover for separate representation although there may be clauses providing for severability of facts and knowledge. The sponsoring company should also have the benefit of cover which should include cover for any indemnities that might have been given thus helping to protect the company's balance sheet.

How the Policy is triggered

- Breach of trust, duty or statutory provision
- Negligence
- Administration errors & omissions
- Improper disclosures or amendments
- Misstatements/misleading statements
- Maladministration

What should be covered

- Errors and omissions
- Damages, judgments, settlements
- Employer indemnities
- Regulatory civil fines and penalties
- Exonerated losses
- Ombudsman awards
- Litigation costs
- Defence costs
- Retirement cover – 12 years
- Full severability of cover
- Individual representation
- Maladministration
- Public relation expenses
- Extradition proceedings/bail bond costs
- Prosecution costs
- Costs re investigations by regulatory authorities
- Mediation & Arbitration
- Court Application Costs
- Third Party Provider Pursuit costs
- Emergency costs

The above should be the minimum cover obtained but some elements of cover will be termed "Extensions". However, in practice they may form part of the main policy without an additional premium. Alternatively, they may only be effective if specified in the Schedule and an additional premium has been paid. Accordingly, it is important to check the position. Trustees should also check they have cover in relation to the data protec-tion powers that have been introduced which enable fines of up to £500,000 to be imposed for serious breaches of the Data Protection Act.

The policy of insurance can be paid for by the company or from scheme assets but if the latter, there must be an express power within the Deed and Rules to do so. As previously mentioned, it should also be noted that if trustees do purchase insurance utilising scheme assets, then the insurance cannot cover civil fines or penalties. In these circumstances, it is usual for the sponsoring employer to pay for this element of cover. It is also perhaps worth noting that trustee liability insurance operates on a "claims made" basis which means that there is potentially cover for claims made against the insured during the policy period irrespective of when the event giving rise to the claim occurred. Therefore, this is another reason to consider taking out insurance sooner rather than later to give protection for mistakes that might have already occurred in the past. However, this will be usually subject to not previously having had insurance and being unaware of the circumstance likely to give rise to the claim when purchasing insurance.

Retired trustees

In addition, a trustee's personal exposure does not cease when they retire and their post retirement situation may make them particularly vulnerable. Problems in pensions often take a considerable time after the event to materialise. It is important, therefore, to check that the position of retired trustees and pension managers is properly protected. The solution is for retired trustees to have the guarantee of cover in the event that the scheme ceases to be insured. They can then rest assured that they have cover personal to them, irrespective of what the employer or trustees have done, or not done, about insurance since they retired. It is again important to check the extent of cover provided in this respect as policies do vary *(OPDU Elite provides 12 years cover from the date of expiry of the main policy of insurance thus giving valuable peace of mind)*.

Court Applications

Trustees and pension schemes can also incur significant legal expense in going to court to seek directions or if they are joined by another party who is seeking the court's directions. Insurance can be obtained to cover these expenses which do not necess-arily involve a legal liability upon the trustees but the scheme will usually be responsible for the legal expenses of all the parties involved. There have been several high profile cases involving costs in excess of £1m which have had to be met from pension scheme funds. *(OPDU Elite provides an extension to reimburse such costs – it is important to note that this type of legal expense would not usually fall within the scope of "defence costs" as defined in many insurance policies).*

Cost and Limits of Insurance: DB and DC

As would be expected, the cost of trustee liability insurance varies according to the size of the scheme and is also dependent on several other factors. However, the cost starts at a few thousand pounds for a small scheme and an approximate indication of cost should be able to be obtained easily for any size of scheme without having to complete a full application.

Consideration should also be given to the most suitable structure for insurance arrangements in instances where there are both Defined Benefit and Defined Contribution schemes with the same sponsoring employer. The differing nature of the risks could produce unintended complic-ations if DB and DC schemes are insured under the same policy with a single limit of cover unless the limit is increased sufficiently.

Also with the continued growth in defined contribution schemes, it is important to recognise that the trustees of such schemes face different legal risks and exposures from those of defined benefit schemes. DC trustees have ultimate responsi-bility for the accuracy of statements, market valuations and increasingly important, the selection and monitoring of investment vehicles offered. These factors increase the risk for claims occurring which has been borne out by claims experience.

Conclusion

Given the personal liability of trustees and their responsibility for managing substantial scheme assets, many trustees and sponsoring employers do appre-ciate the financial comfort that an appropriately structured and cost-effective insurance policy can provide to the assets of the scheme and the company, as well as giving protection to individual trustees. Thus trustees can give a higher level of reassurance to members that their interests are being looked after properly in preserving the scheme assets which is particularly important today when deficits are common. In any event, it is important to review your exposure to risk and to identify any areas for which you do not have adequate protection. Effective risk manage-ment procedures will also assist in minimising liabilities and such pro-cedures should be favourably taken into consideration by insurers.

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A round up of OPDU's recent claims experience

We continue to experience notifications arising out of data errors. These problems are perhaps exacerbated in a time where it is the norm to submit data electronically. A couple of examples are set out below:

Life assurance cover

Following the death of a scheme member, a life assurance claim for over £100,000 was made to the life insurance provider. The life insurance provider refused to pay the claim on the basis that the Sponsoring Employer had failed to include the member on a list of long term absentees provided at the time the cover was taken out. This error by the Sponsoring Employer was a wrongful admission within the meaning of the **OPDU** policy.

Pension Protection Fund ("PPF") levy

A Trustee received a PPF levy invoice that was over five times higher than the amount that the Trustee had expected to pay, based on its own calculations of the Risk Based Levies. The PPF asserted that it had calculated the levy based on the information entered onto the Exchange system by the Sponsoring Employer and that it was the responsibility of the Sponsoring Employer/Trustee to ensure the accuracy of the data provided. The Sponsoring Employer denied that it had made a typographical error when submitting the data and appealed against the levy.

The figures held by the PPF on the Exchange system were used by the PPF to calculate the levy for two years, thus doubling the effect of the apparent error. With **OPDU**'s assistance, the Trustees submitted an appeal to the PPF in respect of both of these levies. One of the appeals was successful, the other was not. In respect of the unsuccessful appeal, the Trustees were able to call on their **OPDU** policy, on the basis that an employee had committed, or allegedly committed, an administrative error in relation to the Scheme.

We hope that the above will be useful in illustrating the financial consequences of simple typographical errors. We strongly advise trustees and employees to print out electronic data and to ensure that it is checked either internally, or ideally externally by your advisers. We also advise you to keep paper copies of any data submitted online.

Early retirement requests

We continue to experience a significant number of notifications arising out of refused early retirement requests. Such refusals frequently give rise to complaints by Members that the Trustees have exercised their discretion improperly. Although the Trust Deed may make it absolutely clear that such requests are within the Trustee's discretion, that does not of course prevent a Member from complaining to the Trustee using the Internal Dispute Resolution Procedure ("IDRP") and, if that is unsuccessful, to the Pensions Ombudsman.

Our experience suggests that where the Trustees consistently approve such requests, Members are more likely to believe that the 'request' is in fact a mere formality. Members are also more likely to complain when they feel aggrieved following redundancy. Trustees should not underestimate how time consuming and expensive such complaints can be, regardless of the merits. **OPDU** is involved with one notification in which the Trustees are still incurring substantial legal costs defending a complaint arising out of a redundancy in 2005.

Equalisation

Notifications continue to be made by Trustees who discover, only now, that attempts to equalise have been ineffective.

By way of example, in a case where the contractual documentation between the Member and the Scheme was amended, but the Trust Deed & Rules was not, the intended equalisation of benefits to age 65 was entirely ineffective. This meant that the Scheme was obliged to pay benefits to Members from age 60. The Scheme unexpectedly found itself facing an additional liability to its Members in excess of £1 million.

Where such errors emerge, the Trustees will, understandably, be anxious to seek compensation for its additional liabilities from the person/entity responsible for the error.

If it is the Trustee who has committed "a wrongful act" during the implementation process, the Scheme can legitimately look to the Trustee for indemnification *(and this would be covered potentially by the standard OPDU Elite policy)*. However, more often than not, the Trustee will have appointed lawyers and actuaries to implement scheme changes and will be able to argue that it has not committed "a wrongful act" because it was entitled to rely on the advice of these properly appointed advisers. If the Trustees have opted for Third Party Service Provider Pursuit Cover with **OPDU**, they can be indemnified for any legal costs incurred pursuing a claim against their advisers.

In another notification involving the implementation of equalised benefits, the drafting of trust documentation was unclear and gave rise to two conflicting interpretations. On one interpretation, the Scheme would have faced an additional liability of around £15 million to its members. Although there was no question in this instance of any wrongdoing by the Trustee, the Scheme had to incur significant legal costs negotiating with its Members and entering into a court approved agreement. This case clearly illustrates the significant cost liabilities that a Trustee is exposed to, even in circumstances where no actual claim has been intimated. Such costs would however be covered by **OPDU**'s unique Court Application Costs cover (an optional add on).

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.

The DC Hospital Pass

Nigel Aston, *Business Development Director at PensionDCisions*

How might those tasked with governing DC schemes best prepare themselves for this new era?

How can we help the members stay on their feet?

For the employer sponsor of a UK pension scheme, moving from DB to DC is all about passing on risk, and who can blame them? However, the transfer of responsibility from plan sponsor to member has been only partially successful. Employers may feel that they have divested themselves of onerous DB uncertainties, but there has not necessarily been a corresponding acceptance of these unknowns by the membership itself. In short, the sponsor has unwittingly executed what is known in rugby as a hospital pass. The hapless member may be about to be brought down by the heavyweight opposition threats of low contributions, volatile capital markets, fluctuating interest rates and uncertain longevity expectations. Unfortunately, as is often the case, the tackled player may take a few others with him or her on the way down. The growing tide of litigation that we see in the States from disgruntled DC participants who feel that in some way they have been misled or badly informed may well become a feature on this side of the Atlantic.

The question this article now attempts to tackle is this. How might those tasked with governing DC schemes best prepare themselves for this new era? How can we help the members stay on their feet?

I believe that the management of these issues can best be addressed through better measurement of the effectiveness of the scheme. I'm going to concentrate on three areas. Firstly, measuring how well rewarded are members for the level of contribution and investment risk that they are taking; determining whether they are making wise decisions (or having wise decisions made for them). Secondly, how we can aggregate the measurement of member outcomes to help the trustees/governance team steer the whole plan effectively in the best interests of everyone. Thirdly, we'll look at measuring objectively whether the default design is doing a good job, in the context of the other choices that could have been made.

It's all about the final result

The only true test of a DC plan is the outcome that the member experiences at retirement. However, waiting for that to be apparent (and therefore, by definition, irreversible) is clearly impractical. To date, typical 'in flight' measures have tended to concentrate on the returns of investment 'products', rather than those experienced by members themselves. Unfortunately, having a portfolio containing 'good' individual funds doesn't necessarily mean having a great overall combined outcome over time. This is because the act of selecting, blending and switching investment products drives asset allocation and therefore the risk and return experienced by each individual consumer. Two members can have the same funds within their portfolio, but experience markedly different outcomes depending on the ratios in which the products are held. This is particularly true in the lifestyle 'glide path' where there is a wide dispersion of results, even though all members of the default hold the same underlying components.

The pensions industry has long relied on reporting fund performance to plan holders, rather than individual portfolio returns. This is extremely confusing for the poor individual, who may be used to entrusting decisions to the trustees under DB and is now faced with a laundry list of complex fund names, numerous unit prices and benchmarks, fluctuating holdings and performance statistics, based on time periods that don't reflect their actual savings patterns.

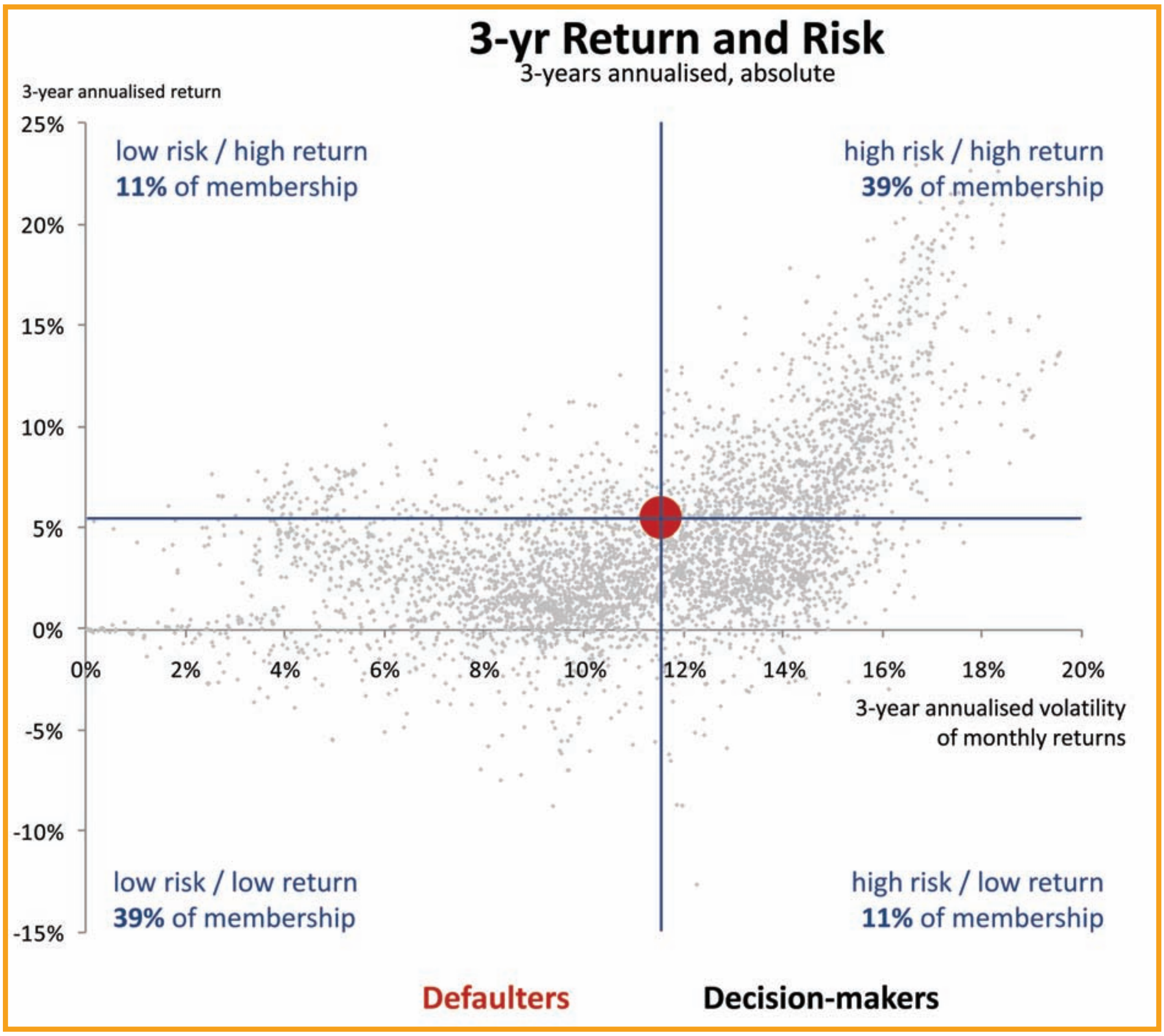
It is essential to the understanding of the member that we start to measure and report portfolio performance at the member level. "Don't tell me how the funds have done – tell me how **I've** done." is the plea we hear from members when they see their benefit statements. Additionally, if we start to employ a consistent, time-weighted and personalised measure of performance, we can tell members how they are doing in relation to people like them. Context is everything. "How am I doing compared to other people like me?" is a question that can be answered and giving people that information should help protect trustees and sponsors from the impact of disgruntled retirees of the future who receive nasty surprises when their pensions are not as anticipated.

Furthermore, although the final result is crucial, we should also remember that you have to stay on the field to get there. Returns are critical, but so is the volatility experienced. Making sure that they avoid too many unanticipated knocks on the way is vital to most savers. However, the measurement and clear articulation of the investment risk that goes hand in hand with return is something that we don't tend to see often in member-level reporting. Moreover, without the saver appreciating that taking some risk can be a good thing, there is a danger of reckless conservatism and a retreat to cash. When people say "I'd have been better off putting it in the building society" they don't actually know that, unless we can calibrate their own risk and reward signature and explain it in a simple way. It's important that we find a consistent and understandable way of communicating this vital element.

Given this simpler aggregated approach to reporting risk and return, we can start to present these measures in a visually appealing way that people can understand more easily. We can employ compelling, segmented and personalised messages to communicate with employees about whether they are on track to an adequate retirement. As well as aiding understanding and guarding against future surprises, this will also impress upon the members the value of their scheme and improve their appreciation of the sponsors' benefit spend. In short, a simple, well articulated and presented, individualised report to members, that includes the key elements of portfolio risk and return, will go a long way towards ensuring that we are not storing up problems for the future.

It's a team game

Once we know the outcomes that are being experienced by individual members we can build a bottom-up aggregated 'x-ray' of the scheme as a whole. This will enable the trustees or governance team to see instantly whether there are outliers whose emerging outcomes may be out of step with the majority and who may represent possible sources of future litigation. It will also support corporate efforts to cement and leverage the scheme as a key tool for attraction and retention of staff. As we know, DC is all about individual choice and we don't necessarily want to encourage a situation where we see everyone clustering to the consensus, but good governance should help people avoid the nasty surprises.



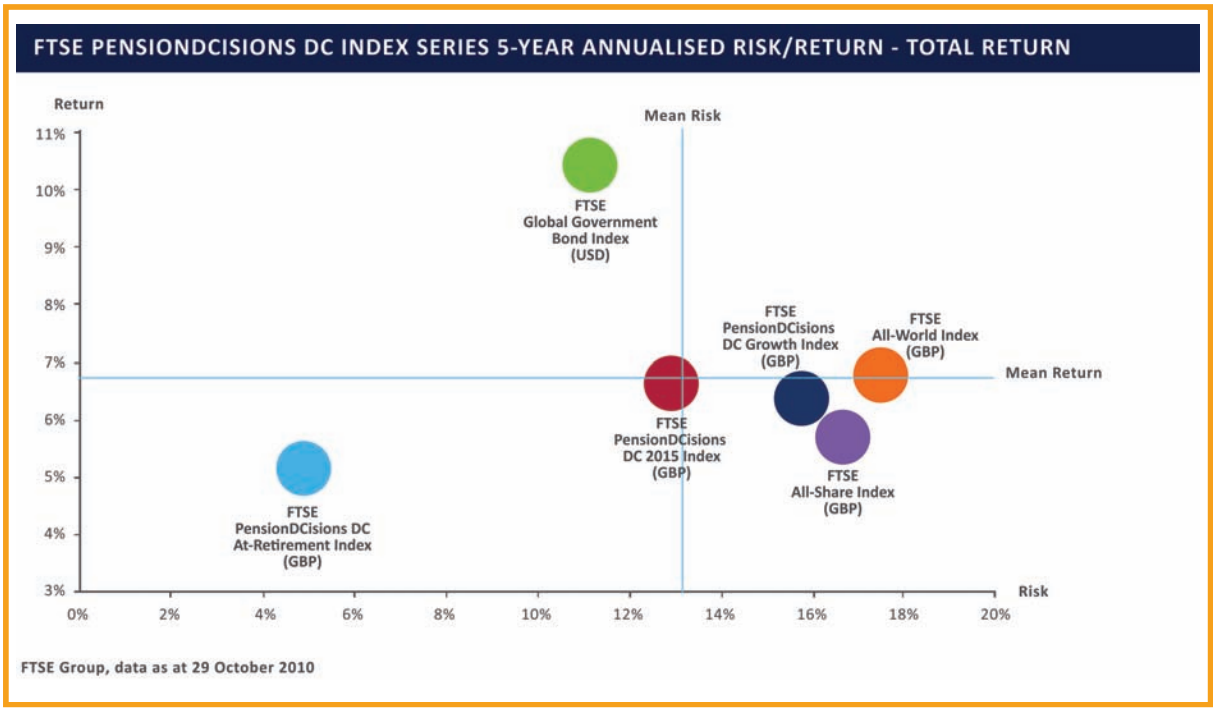
Footnote: Each point on the scattergram represents the actual performance of the participant. By plotting the risk and return signatures of actual DC members, we can start to see which individuals may represent a potential problem. In this example it would appear that 11% of members are being badly rewarded for the risk they have experienced.

To err is human, to forgive default

Over 80% of DC members are in default funds. The evidence makes it apparent that the choices made by those formulating the default strategy have the most critical investment effect on outcomes for the consumer. Who is setting the objective for the fund? Who is undertaking the asset allocation decisions to achieve this? Who is picking the underlying managers, passive or active, to deliver the performance? Who is monitoring and tweaking the strategy as it develops? Are they all pulling together? But beyond these important questions, measuring effectiveness is also about forming comparisons with the alternatives available.

Investing someone else's money is always a subjective process. An individual DC pension plan monitoring its performance in isolation, for example, relative to the FTSE 100 or 'cash plus' can lack critical insight into how much risk is being taken and whether it is being fairly rewarded in comparison with other alternatives. To this end PensionDCisions has recently launched, in conjunction with FTSE, the FTSE PensionDCisions DC Index Series.

The index series is designed to reflect the actual asset allocation decisions



Footnote: by measuring the risk and return of actual DC plans, the FTSE PensionDCisions DC Index Series provides a valuable and objective measure, against which all DC schemes can judge the effectiveness of their own default strategy.

made by leading UK DC plans for their default strategies. It provides an objective assessment of the risk and return these solutions deliver. Until now, this transparency has been missing from the DC market, making it virtually impossible for plans to measure or monitor objectively the performance that is actually being delivered to the average consumer reliant on these solutions in comparison with other similar schemes.

The index adopts a target date maturity approach, enabling investors to assess their DC scheme performance in terms of both risk and return throughout the member lifecycle. The index series is based on the PensionDCisions Sponsor Default Survey, running since 2007, and has received widespread and explicit support from The Pensions Regulator, the National Association of Pension Funds, the PMI and so on.

I would urge schemes to engage in the survey. In return for completing a very short questionnaire you will receive a comprehensive report on the health of the UK DC marketplace that will allow you to put your scheme into context with other plans. In addition, you will be helping to establish an independent and valuable measure against which we can help to govern DC solutions. *(For more information on either the index itself or the underlying survey that supports it, please go to:* **www.pensiondcisions.com/solutions/ftsepdc***)*

Into the long grass

So, the key risks of the DB may have been divested by the sponsor, but now they face different potential problems under DC – those of reputational damage and possible litigation.
Historically, the concentration of effort from trustees and their advisers has been directed towards DB. This is understandable; it's only natural that resource and time is applied in proportion to the assets (and liabilities) involved. However, as DC funds grow relative to DB, there is an increasing level of scrutiny and rigour expected from the regulator and it's also clear that contract-based provision is not the governance-free zone that sponsors may have hoped for. Effective DC stewardship is becoming a critical piece of the trustee jigsaw.

For better or worse, it's rapidly becoming a DC world and those who can measure the effectiveness of their plans most effectively will find it a much more comfortable one.

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Fount of all knowledge

Terry Ritchie, *Head of Management Consulting, Capita Hartshead Actuarial and Consultancy Services*

Pension scheme Trustees will be familiar with the terms 'governance' and 'risk'; however these terms are usually associated with investment and running the scheme. An area that can often be overlooked is key person risk. A key person can be the Pensions Manager, an administrator or another key contact. While the loss of a key person can have a dramatic impact on a pension scheme often Trustees have not considered this and have no contingency plans and this has caused many a problem.

The Sage

Over the life of a pension scheme there will be numerous changes to the rules, procedures and practices. These will reflect over-riding legislation and changes made to the scheme by the sponsoring employer or Trustee. One would hope that these changes have been captured and documented by the legal team and reflected correctly in the Trust Deed & Rules and Deeds of Amendment. However, the Trust Deed & Rules are not always updated in a timely fashion to take account of new over-riding legislation and you can start to get into the paper stream of Amending Deeds, which can be time consuming. There are some schemes that keep a comprehensive schedule of changes but, sadly, this practice is not always followed. As time evolves, all of the changes can sometimes become a blur but, usually there will be a key member of staff who has been through it all and will remember the changes. They will know what impact each change had on the scheme, how processes evolved and importantly, how member benefits are to be calculated. Many schemes have such a 'sage' who is the fount of all knowledge. They will remember individual cases and how their trustees exercised their discretion and may also have copies of all the old scheme handbooks stashed away in the desk drawers. These people are the 'crown jewels' of the workforce and can cope very easily with anything that is thrown at them. As a result, you may find that the scheme history and practices are not always fully documented, and the knowledge is not disseminated to others. This type of position presents a huge risk to the scheme. Reality starts to kick in and the alarm bells ring when your 'sage' decides to leave or retire' falls ill or wins the lottery and they are no longer there to answer questions. This is when panic sets in; how do you calculate benefits for a category of members (or understand the rationale)? when did the change take place? These are just some of the questions that will start to be raised.

History of scheme events

To illustrate the point, if you look back over 35 years, which is not a long time in pension scheme terms, we have seen numerous Pension Acts and other changes to legislation. A good example of this is how provisions for contracting-out have evolved – equivalent pension benefits, equalisation, guaranteed minimum payment and protected rights. Then there has been anti-franking, equalisation, preservation (a subject all of its own), the Pensions Act 1995, different statutory increase rates relating to different elements of pension. In 1997 we saw many schemes make changes to take advantage of the NI rebates offered to contract-out on a money purchase basis. Simplification also further added to the pension puzzle with further regulations. These are just some of the changes driven by legislation, but Trustees also need to consider the changes that have taken place in their scheme which emanated from the sponsoring employer. Have there been changes to the accrual rate? Has the definition of pensionable pay or normal pension date changed? What happens to benefits for members who divorce? Has the scheme moved to a career average revalued earnings basis? The list goes on. We have not even considered corporate activity and the impact this has had. Although Trustees and Pensions Managers are busy coping with current issues of the day, the history needs to be captured, preferably before your 'sage' leaves you for what ever reason. We are all familiar with the comment of school children, 'why do we study history, what value does it add?' Well in the pensions' arena, history is vital and documentation is king. We are all aware of the recent communications from the Pensions Regulator regarding the quality of data and record keeping. Although not directly comparable, the history of scheme events is another scheme record which, if incorrect or not kept up to date, can have a direct impact on pension scheme members and the costs of running the scheme. Furthermore, the Pensions Regulator has indicated that pension scheme administration will be an area that they will be concentrating on during 2011 and scheme history, yet again, impacts on the service to pension scheme members. So Trustees, are you confident that you will not be exposed?

The way ahead

So, hopefully by this stage you are either convinced by the arguments and you are beginning to panic or, you are one of the lucky few who either have no problems or you have documented everything. If you are the former, then what can be done to relieve your panic? Let us have a look at the potential remedies. These cover documentation, automation, training and education. The first step is always going to be documentation of your practices, ensuring that dates of changes are included and the finer points of the decision process are clearly set out. This will always be the foundation to reducing key person risk. Documentation should include; legal - Trust Deed & Rules, Deeds of Amendment; procedures – how to – the administration bible which includes current practice and a separate section covers the history, not only how but why; process maps are useful documents to hold, together with pro formas both current and historical even if you have automated calculations.

Automation of processes, calculations and practices will also reduce the risk, although the rationale for any decisions should always be known (and documented) – it should not just be a mechanical solution. Having a 'press button' mentality without checks based on knowledge, experience and a clear understanding of changes to the scheme, can present you with other problems. Remember, it is much harder to retrieve an overpayment of benefits than getting it right in the first place. Even worse is an underpayment, the pension scheme members will not thank you, or the Trustees or worse the Pensions Regulator. Training and education of staff is a major part of removing key person risk. Well trained and educated staff are valuable to any operation but, especially so in the pensions arena. Clear training plans which cover legislation, scheme history, practices and requirements will go a long way to mitigating key person risk. An ongoing education programme is vital together with refresher courses.

Looking to the future

Although Trustees may have a problem with understanding the history, they should make sure that they do not compound any problems in the future. We are seeing many schemes undertaking de-risking exercises which will involve consultation with scheme members and changes to benefit structures, accrual rates and potentially the type of scheme. Furthermore, in the near future, employers will have to make decisions about the type of pension scheme(s) they will have in place post 2012 because of auto-enrolment. While the history may take time to capture, putting in procedures for the future should be relatively straightforward. The key steps are to:

- Identify key individuals and establish the level of risk their 'loss' might pose
- Audit scheme documentation to see if there are any gaps and establish the extent to which current and historical procedures and practices are records
- Devise a system for clear documentation of procedures, scheme changes and education programmes and implement this for the present and the future. This does not have to be onerous or involve vast ranks of filing cabinets, there are a number of online 'trustee secretariat' services designed precisely for this task
- Draw up a plan to collect together all scheme documents, including member handbooks and record any historical changes to procedures and practices

Running a pension scheme whether as a Trustee or Pensions Manager is an important role; governance and risk are high profile, so it is essential to mitigate risks, especially key person risks. Who knows, one day your 'sage' who has been there for longer than anyone can remember, may one day depart and leave you exposed.

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You've Got The Power

Hamish Wilson, *Managing Director, HamishWilson & Co LLP*

Trustees have considerable power when it comes to running their pension scheme. They have power to set investment strategies and funding policies. Collectively they have more power now than they ever had. Yet many trustees may feel the weight of this power too much for them. Many may be tempted to abdicate their power and take a back seat, leaving their advisors to effectively exercise power on their behalf. Other trustees may be unaware of their powers perhaps because they are railroaded by their consultants' process and either are unaware of their powers or feel unable to resist or arrest the position.

The inevitable result is often conflict and confusion: conflict with the sponsor when it comes to setting achievable funding policies and confusion over the ability and willingness of the sponsor to support the scheme in the long run. This is not the intended result of giving trustees power. They were given powers so they can exercise them in a way which encourages sponsors to take the pension commitment seriously and reassure members this is being achieved.

Pension schemes work best when the trustees are engaged and can work with the sponsor to achieve the common objective of a well managed and well financed pension scheme. Within the industry we would do well to remember this, especially when constructing governance mechanisms. "Good" governance need not simply be the construction of barriers and protocols aimed at driving an immovable wedge between trustees and sponsors. Instead, good governance should encourage an open, healthy relationship between the two parties.

Being commercial, tactics and more subtle approaches

Trustees can and, I believe, must be commercial and should not be afraid to enter into commercial negotiations with sponsors, particularly in the current economic climate.

In any negotiation, it is unwise to have one hand tied behind your back, so trustees should avoid being boxed into a corner by advisors and others taking too hard a line in the name of 'prudence'. I do not think it prudent for the trustees to drive sponsors so hard the pension scheme threatens sponsors' very existence: a healthy sponsor is a prerequisite for a healthy pension scheme (and is the only option if benefits are to be paid in full).

And yet the risk of being overly prudent is strong. Trustees may be frightened into it or, worse, advised into it. In the former case the constant reminder of corporate and market volatility itself can drive trustees into thinking their job is to get as much money from the sponsor as quickly as they can. This may sound good, but is it really a sensible way to conduct long-term funding strategies?

Surely it does not make sense to tie up huge sums of money in a trust with little or no prospect of any overfunding ever coming back to the sponsor. And yet prudence may drive some to regard this approach as preferable to more subtle claims on sponsors' finances.

Contingent assets and asset-backed funding

Would prudence be better interpreted as meaning putting something into a contingent arrangement? For pension schemes, the contingency is benefits costing more than anticipated. The sponsor is more likely to be amenable to such prudence if the contingent funds can be returned if they are not needed; even better if the funds can be used to support its business in the meantime (as in the case of asset-backed funding).

Trustees will naturally look to their actuary to help them structure their funding plan. The triennial valuation is the natural opportunity to review and agree investment and funding strategies. The actuary will play a vital role in that process and can outline options and discuss appropriate assumptions. This will extend to some trustee training. But the actuary can only go so far in this debate. He or she will not fully understand the sponsor's investment needs, the strength of the sponsor's covenant or the worth of assets used in its business. Whether because of this lack of understanding, or for reasons of commercial or professional pressure, the actuary may be tempted to value cash in hand above any other asset.

Similarly, the investment advisor will be expert in the market and the latest products on offer, possibly developed by his or her own firm, but will he or she fully appreciate the investment opportunities the sponsor itself has to offer? A contingent investment in the sponsor as a means of solving the problem of providing a funding margin but without tying up assets unnecessarily in the scheme may be difficult for the investment advisor to fit into his latest thinking and therefore give advice upon.

Double dose of prudence

The trustees may also be led by advisors who are acutely aware of their own commercial position. The trustees must be prudent, everyone tells them so. Advisors often feel they must be even more prudent, not just to satisfy pension regulators, but also to support their own business model, their internal risk management and regulators.

Even worse, they could be under considerable pressure to promote the 'house view' which, almost by definition, has been developed for all clients. The probability of it being suited to any one client must be a concern.

These are examples of where trustees are at risk of an unhelpful double dose of prudence.

The advisor may even suggest hiding behind the regulator which would be misguided and make matters worse.

We do not want more regulation and it is pleasing to see the Pensions Regulator is aware of the implications of being drawn on the approach for scheme specific funding. Not only would that contradict the 'scheme specific' objective but hopefully the regulator is mindful of the wider implications of stepping into the breech.

Won't someone tell me what to do?

Some trustees may be comforted if they are told by their actuary what to do; told by the sponsor how much they can afford; told by the Pensions Regulator when they are out of line and covered by the Pension Protection Fund if all this goes wrong. But I wonder whether this is really what trustees are there for: to do what they are told? Trustees need to ask themselves 'if it all goes wrong and they are required to justify their actions before a Court, will this stance hold water?'.

The trustee will want a full discussion with their advisors; a good trustee will look to challenge their advisors if only to make sure they fully understand the issues appropriate to their circumstances. But do trustees really want advice encumbered by their advisors' professional or commercial pressures?

Furthermore, do trustees really want advice which constrains their actions? Sometimes it will be so covered in caveats it is hardly worth the trouble. At other times it may be covered by a double dose of prudence which could do even more harm than good. Another problem is, once advice is given it can hardly be ignored; trustees would do so at their peril. So unless carefully managed, advice can box trustees into a corner and so limit their room for manoeuvre and may frustrate the most appropriate commercial outcome.

Perhaps we need a better approach.

A more robust and commercial approach

Perhaps the trustee should be less insistent on being told what to do. Perhaps the advisor would be able to say more if he or she does not give advice at all. If the advisor merely informed the trustees of the issues; merely gave views and outlined the options and the implications of each option (but did not go so far as to advise – which means tell – the trustees what to do) we would have a better outcome.

So, instead of herding trustees into corners impossible for them to get out of and difficult for the sponsor to agree to we should encourage trustees and sponsors to enter into proper commercial negotiations. Sponsors and trustees should have a sensible and informed dialogue, where both parties use their advisors more wisely but ultimately make their own decisions and take responsibility for them.

Implications for the calibre of trustees

Many may say the self-thinking, decision-making trustee outlined may be too hard to find. Where can you get someone who has the determination and ability to understand the nuances of actuarial funding methods and latest investment strategies and yet still retain a firm grounding in what is commercially achievable and sensible for scheme and sponsor in the round?

Professional trustees have a role to play here, but are not essential. They will invariably have the understanding and may even be actuaries themselves, but they are exposed to many of the issues described earlier. So we would not want our trustee board to be run totally by professionals. The "lay" trustee has a vital role to play, not only in bringing some common sense and understanding of the business and the membership to the table, but also in challenging the professionals and ensuring whatever solution is being discussed on a particular issue is relevant to their circumstances.

A key quality required of trustees is the confidence to challenge advisors thoroughly. This is essential for member-nominated trustees who are often unfamiliar with boardrooms and dealing with highly paid consultants. Trustee training helps and is even more important now many senior employer-nominated trustees are resigning as trustees due to conflicts of interest.

If you don't use it, you lose it

It is in everyone's interests trustees get involved and take responsibility for their own decisions.

They need the freedom to do this and so should be looking to their advisors to inform debates and the decision-making process, but not to drive it. It is in the sponsor's interest trustees are engaged and commercial and contingent assets may well represent a 'win win' situation. Trustees must be wary of advisors who will be inclined towards a double dose of prudence; driven by the constraints of house views and/or firm-wide risk management.

In particular, actuaries have no real insight into the covenant which can make the actuarial approach second order. Indeed, where a wider perspective is taken to funding strategy, the actuarial approach serves only to determine how the overall funding strategy is met as between cash, contingent assets and the sponsor's covenant.

The bottom line for the trustee is you are in a commercial situation. Use your advisors intelligently by listening to their views but arrange matters so you retain the power. Listen also to your sponsor and enter into a proper commercial negotiation.

You have the power to act in this way; if you don't you may lose control which may not be in the interests of your members. If you don't use it, you lose it!

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Credit outlook 2011: Back to basics

Ben Bennett, *Credit Strategist, LGIM Active Fixed Income*

Following such a stellar performance during 2009, many investors doubted the ability of corporate bonds to post strong total returns again in 2010. However, that is exactly what happened. Now, at the start of 2011, the asset class appears constrained by the dual handicap of low government yields and compressed credit spreads as it faces the headwinds of inflation, peripheral European sovereign risk and an investor base seemingly desperate to re-enter the stock market.

The following article explains why corporate bonds may continue to triumph, despite such adversity.

A remarkable year, again

The past two years have been very good for corporate bond holders. Total returns have been strong across the globe **Figure 1**, despite initial concerns that 2010 could struggle in the shadow of the exceptional gains of 2009.

We believe that this strong performance should be viewed as a correction of the dire conditions of 2007 and 2008 rather than as a benchmark for future performance. **Figure 2** breaks down returns for the global corporate bond index into the underlying return from the performance of government bonds and the excess credit return that comes from taking corporate bond risk (i.e. some extra yield combined with price fluctuations as a result of this corporate risk). In 2007 and 2008, we witnessed large negative credit returns as the market suffered a number of defaults and re-priced corporate bond risk premium. While falling government bond yields mitigated the impact somewhat during 2007, resulting in a positive total return, they failed to do the same in 2008.

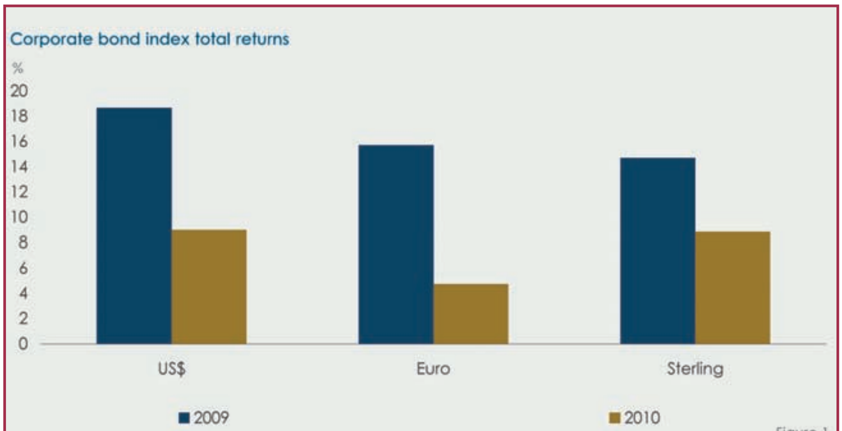

Figure 1
Source: BarCap Corporate Indices, LGIM

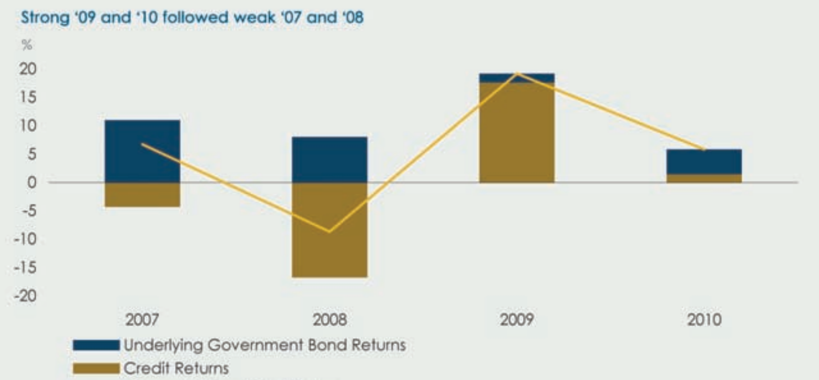

Figure 2
Source: BarCap Global Corporate Index, LGIM

Corporate bonds bounce back

Credit risk then reversed direction dramatically in 2009 as corporates recovered from their dire position. Some of this also fed into 2010, but the majority of return during this year was from falling government yields as central banks kept interest rates at extremely low levels and continued quantitative easing programmes to help revive the economy.

As a result of this prolonged recovery, underlying government bonds yields are low and the excess credit yield has compressed significantly from peak levels. From this starting point, how do we expect corporate bonds to fare in 2011 against a backdrop of inflationary concerns, peripheral European sovereign risk and a potential investor shift into equities?

Inflation

Clearly, very low underlying government bond yields are a concern. **Figure 3** shows this compression, plotting yields of various corporate bond indices once the excess credit yield has been stripped out. Given that yields cannot fall much further before they reach zero, it is therefore understandable that investors dwell on the risk of aggressive rate increases from central banks in the face of burgeoning inflation.

Risks remain

However, high inflation is not the only risk to the economy. Indeed, the current low level of government yields reflects the fact that the US continues to pump money into the system to try and reduce historically high unemployment. Also, the Euro-zone is suffering a very mixed growth profile with many countries still struggling to post positive growth numbers. In the UK, the risk of a double-dip recession remains as austerity measures hit home. In other words, deflation remains a possibility for many economies along with associated prolonged low interest rates and even further quantit-ative easing. As we have seen in Japan during its 'lost decade', it is even possible for government yields to fall further from where they are currently, and remain there for a considerable periodof time.

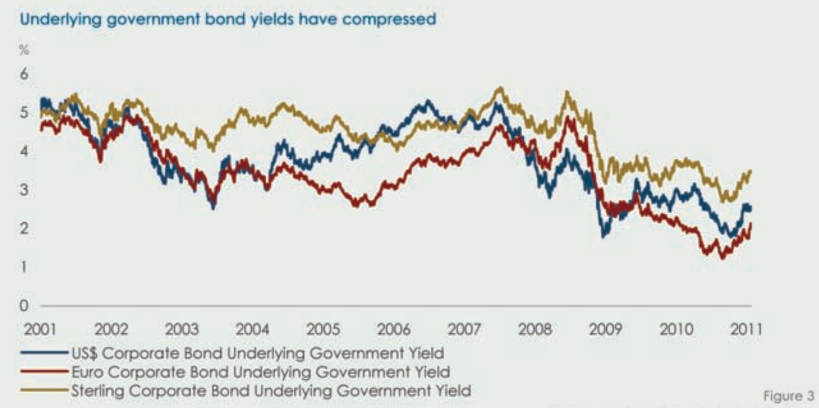

Figure 3
Source: BarCap Corporate Indices, LGIM

A 'buffer' in place

While a further economic slowdown would be good from an underlying government bond point of view, the excess credit yield portion of a corporate bond would suffer. But as **Figure 4** demonstrates, even after the contraction of the last two years, excess credit yields remain considerably higher than during the pre-crisis years and more in line with levels seen during the 2001/2002 recession.

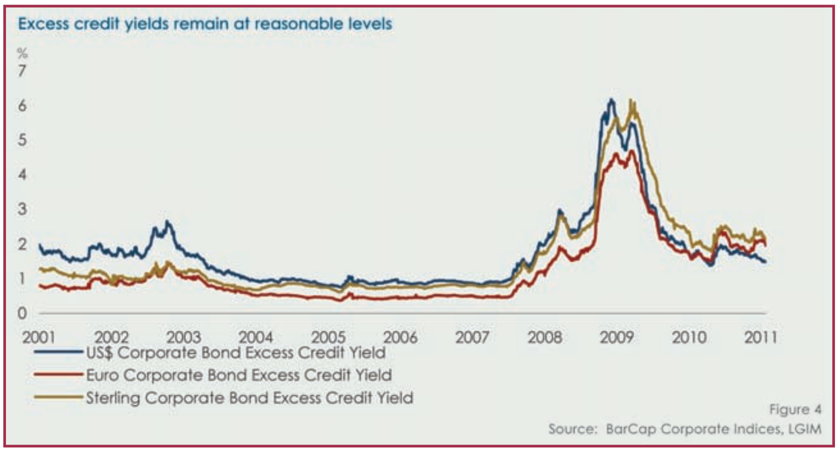

Figure 4
Source: BarCap Corporate Indices, LGIM

This provides investors with a reasonable cushion against economic deterioration going forward. Indeed, should inflation risks materialise and government yields head higher, this excess credit yield again provides a buffer as better economic growth should reduce credit risk premium.

The worst-case economic scenario for corporate bonds is probably 'stagflation', where economic growth remains sluggish even as inflation heads higher. However, it is hard to find any asset class that benefits from such a combination. Corporate bonds would suffer, but they might not significantly underperform government bonds or equities in a stagflation scenario.

Peripheral European sovereign risk

A year ago, we believed sovereign credit risk was one of the key "tail risks" for corporate bonds in 2010 – and this remains the case in 2011. Over the past 12 months, we have witnessed the emergency bailing out of Greece, a further banking crisis in Ireland leading to the sovereign asking the European Union for help as well as bouts of significant volatility within the Portuguese, Spanish and even Italian government bond markets.

Within the Eurozone, structural reform and austerity measures are being implemented. However, all of this is being done in the glare of the international bond markets, which can turn off the financing tap at any point, forcing countries to access rescue mechanisms. Of greater concern is that the current mechanisms do not seem large enough yet to cope with the next round of potential funding requirements.

While we would like to believe that European policymakers can finally gain control of the situation, proactively recapitalise struggling banks and provide cheap alternative financing to embattled countries, recent experience suggests that this is unlikely.

A period of volatility

The most likely outcome, in our opinion, is that Spain will be forced into funding difficulties before the necessary long-term solutions are agreed. The political willpower probably exists, given that the alternative of a Eurozone breakup would be disastrous. However, even if the final outcome is supportive for financial markets, the period that followed a Spanish funding crisis would be very volatile.

Investment strategy

As we proposed in an article in February 2010 (*Corporate bonds: 'Beware the tail-risks'*), we believe the best way for a corporate bond fund manager to protect their portfolio from peripheral European sovereign risk is to be cautious when it comes to investing in 'captive corporates' from affected countries. These types of companies typically have a large proportion of revenue and profit derived locally or significant assets located in the single country.

In addition, as we saw with the Irish bailout, it is almost impossible to separate the health of the banking system from the sovereign. Indeed, the well publicised interdependency of the European and even global banking systems reinforces the link between bank bond performance and peripheral European sovereign problems.

Therefore while tensions continue to mount, corporate bond managers can use the credit default swap market and buy insurance against the possibility of a portfolio of banks defaulting.

Through careful risk management in the lead up to what could become a Spanish financing crisis, corporate bond investors can reduce the volatility of their investment, while also positioning themselves to benefit if a longer-term solution is eventually found and risk appetite improves.

Demand flowing into equities

The final headwind facing corporate bonds is actually a reversal of a theme that supported the asset class during the past couple of years. Fed up with the volatility of the equity market and attracted by historically high corporate bond yields, investors piled into corporate bonds (particularly during 2009), supporting performance despite the fact many corporates were aggressively issuing bonds to address their struggling liquidity positions.

As economic growth prospects are revised higher and as yields rise due to inflation fears, the same investors may be tempted to switch back into equities, potentially reversing this positive support. Indeed, there have been weeks around the turn of the year when retail flows have reflected such an allocation shift. However, the impact should not be overblown.

Still in demand

Many retail investors who have traditionally focused on the equity market will now have had a pleasant experience with corporate bond markets potentially leading them to view this asset class as a fundamental building block for their portfolios in the future. In addition, institutional flows into corporate bonds are likely to remain supportive. Recent equity market volatility has reinvigorated the determination of many pension funds to de-risk and move into bonds where possible. Indeed, as equities rise, thereby closing funding gaps, we expect an ongoing shift into bonds that should dominate any retail outflows.

On the supply side, recent heavy corporate bond issuance should also moderate going forward as companies complete their debt maturity extension and reduce their reliance on bank funding. While the strong supply/demand dynamic may moderate somewhat in the future, it should remain supportive for corporate bonds.

Bottom Line

Given the fall in government bond yields and the reduction in excess credit yield, corporate bonds are not as attractively set up for 2011 as they were in 2009 and 2010. That said, while 2011 growth is likely to be robust and inflation is an increasing concern, the global economy still faces a number of hurdles. As the corporate bond market gets back to basics, we expect reasonable upside potential with the added protection of a healthy excess credit yield against risks to growth, inflation and peripheral European sovereign concerns. We expect the asset class to post total returns of 3% to 5% in 2011.

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Six Continents Ltd
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