



Institute
and Faculty
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Hot Topics in Pensions Law

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What we plan to cover

- GMP equalisation
- Case law update
- ESG investing and new disclosure obligations



GMP equalisation

Implications of Lloyds Bank judgment

Recap: impact of GMPs in a defined benefit scheme

- Between 6 April 1978 and 5 April 1997 a company's defined benefit occupational pension scheme could "contract out" of the state earnings related pension scheme.
- If a scheme contracted out, members were entitled at statutory pensionable age (60 for women, 65 for men) to receive a weekly pension not less than the "Guaranteed Minimum Pension".
- Most contracted-out schemes provided benefits in excess of the statutory minimum so members accrued a GMP element and an "Excess" element.
- The rules governing GMPs are found in the Pension Schemes Act 1993. They provide that:
 - the GMP must be payable at "pensionable age" – 60 for women, 65 for men;
 - it is calculated by applying revaluation in deferment up to pensionable age;
 - GMP is increased in payment from pensionable age; and
 - a late retirement increase is applied if it is not put into payment at pensionable age.
- The rates of escalation and revaluation will often differ for the GMP element and the Excess element.
- The unequal payment age for GMP, combined with the differing rates of increase applicable to the GMP and to the Excess, cause a man and a woman with equal age, service and earnings to have different pensions in payment.

The roles of the parties in the *Lloyds* claim

- A Part 8 claim was brought by the Trustee of three of Lloyds Banking Group's pension schemes. The Trustee played a neutral role in the proceedings.
- Interest based representation:
 - Three representative beneficiaries made arguments on behalf of those members in whose interests it was for the Trustee to equalise benefits.
 - The Banks made arguments on their own behalf and on behalf of those members in whose interests it was for the Trustee not to equalise benefits.
- HMT and DWP were joined to the proceedings.

The claim in the *Lloyds Bank* litigation

- **The issue:**

- European law (Article 157 TFEU) requires each member state to ensure that the principle of equal pay for male and female workers for equal work or work of equal value is applied. Occupational pensions are pay (*Barber*).
- Section 67 Equality Act 2010 (“**EA10**”) provides that any occupational pension scheme which does not include a sex equality rule is to be treated as including one.
- The effect of a sex equality rule is to provide that if a “relevant term” is less favourable to A than it is to B, the term is modified so as not to be less favourable.
- A term is “relevant” if it is a term on which persons become members of the scheme or if it is a term on which members of the scheme are treated.

The claim in the *Lloyds Bank* litigation

- **The questions put to the Court**

- Is the payment of unequal pensions to male and female members as a result of the requirement of the GMP legislation in breach of the sex equality rule deemed to be incorporated into the rules of pension schemes by s67 EA10 and contrary to the directly effective rights of scheme members to equal pay under Art.157 TFEU?
- If it is, is there one single method that must be used to equalise?
- If there is more than one method, then which one should the Trustee use?
- Are trustees required to make back payments and if so over what period, and should interest be applied?

- **Questions not answered by the Court**

- Is it possible to adopt a different method for *de minimis* members?
- Are trustees required to revisit previous transfers out?

Issue 1: liability

- **Question**

- Is there an obligation on the Trustee to adjust the Excess benefits to equalise for the effect of GMPs or is it lawful to pay unequal pensions because:
 - a) GMPs are part of the state social security scheme and are therefore not “pay” within Art. 157 TFEU;
 - b) there is an objective difference between men and women arising from the GMP legislation; and/or
 - c) there is a material factor defence under s69 EA10.

- **Answer**

- Yes, there is an obligation to equalise for the unequal effect of GMPs
 - a) No, GMPs are not part of the state social security system. It does not matter that they are a substitute for SERPS, properly characterised they are “pay”.
 - b) No, there is no objective difference between men and women; the differences resulting from the legislation are based on gender. This cannot comprise an objective justification.
 - c) No, there is no material factor defence for the same reason.

Issue 2: methodology

- **Question**

- If there is an obligation to equalise for the effect of GMPs, is there a choice of methods by which equalisation can be effected?
 - a) What is the “relevant term” which must be modified?
 - b) What role does “minimum interference” play?

- **Argument on “relevant term”**

- Widest interpretation looks at each element which impacts the calculation of the pension separately – i.e. revaluation, anti-franking and increases
 - This interpretation supports “Method A”
- Narrower interpretation looks at the overall amount of pension paid as the “relevant term”
 - This interpretation supports one of the other methods (B, C or D)

Issue 2: methodology

- **Method A: equalises each unequal aspect of the GMP and Excess separately**
 - Puts into payment the higher total pension that would be paid to the unequalised female or the unequalised male. At each subsequent annual increase, the total increase that would be paid to the (un)equalised male and female is compared, and the higher increase is paid to both sexes.
- **Method B: higher of the two annual pensions is paid to both sexes each year**
 - Each year the total pensions payable to the unequalised female and to the unequalised male are compared and the higher of the two is paid to both sexes, i.e. the pension of the disadvantaged sex is uplifted to meet the level of the pension received by the advantaged sex.
- **Method C: each sex receives the same cumulative total pension**
 - Each year an annual pension is paid to both sexes that would result in the accumulated pension instalments paid to date equalling the higher of the accumulated pension that would so far have been paid to the unequalised female or unequalised male. (Can include applying interest to account for the time value of money (referred to in the judgement as C2)).
- **Method D: pays benefits of equal actuarial value**
 - D1 – An actuarial value is placed on the projected benefits of the unequalised male and female. The sex with the lower actuarial valuation is awarded an additional benefit equal in actuarial value to the difference between the two.
 - D2 – As for D1, it places an actuarial value on the projected benefits of the unequalised male and female and the values are compared. The whole pension of both sexes is then converted into a re-shaped non-GMP pension, using the GMP conversion legislation, with an actuarial value equal to that of the advantaged sex.

Issue 2: methodology

- **Answer**

- The “relevant term” is the overall benefit and not the individual calculation factors (i.e. Method A is not the only method that produces equality of treatment).
- This means that there is more than one method which could produce equality of benefits.
- If there is more than one method, then the method to be used is the one which produces “minimum interference” with the rights of any party.
 - Method A offends the principle of minimum interference from the Banks’ perspective; therefore the Trustee is not entitled to adopt it.
 - Method D1 offends the principle of minimum interference from the members’ perspective (because it interferes with their rights to receive payments due under the scheme levelled up to remove any inequality); therefore the Trustee is not entitled to adopt it.
 - Method D2 would be permissible to the extent that it makes use of the conversion legislation (because the legislation effectively sidesteps the question of minimum interference) but it is not available at present because the Banks do not consent to it.
 - Methods B and C provide equivalence. The only method the Trustee can adopt (unless otherwise agreed with the sponsor) is C2 (relying on the principle of minimum interference judged from the position of the Banks).

Note: the Court held that the conversion legislation is effective as currently drafted

Issue 3: back payments

- **Question**

- If there is an obligation to equalise, are trustees obliged to make back payments and, if so, how far back?
- Should interest be applied to back payments and, if so, at what rate?

- **Answer**

- Beneficiaries are entitled to receive arrears of payments due to them.
- The period for which beneficiaries are entitled to back payments is governed by the rules of the scheme.
- The Limitation Act 1980 does not afford a six year limitation period on the recovery of back payments.
- Interest should be payable on arrears; the appropriate rate is 1% above base rate.

Note: the Court's finding on limitation periods will have wider ramifications and could affect all claims for back payments. Scheme rules will be important.

Commentary and next steps

- The decision on liability is unlikely to be a surprise.
- Open legal issues
 - Transfer payments
 - Application of anti-franking test
 - GMP only members
- Application on buy outs
- The key issue for schemes and their advisers will be implementation
 - What state is member data in?
 - Do schemes even have the right data splits?
 - Administration systems
 - Options to simplify implementation?
- Next steps



Case law update

Frozen schemes, improper purpose and transfer scams

G4S plc v G4S Trustees Ltd

Background

- 2 sections of the G4S Scheme closed to future accrual in 2011
- But members retained a final salary link
- Question arose due to administrative difficulties caused by trying to avoid running out of active members
- Were these sections “frozen” for the purposes of the Employer Debt Regulations?

G4S plc v G4S Trustees Ltd

Decision

- G4S successful
- Members with final salary link are not in “pensionable service” after closure date because they are no longer building up “units” of pension
- Final salary link was a way of quantifying benefit which had already accrued at closure date
- Post closure service did not qualify for further pension but only affected its quantification by way of the final salary link

G4S plc v G4S Trustees Ltd

Implications

- Resolves uncertainty that has existed for many years
- Employers and trustees of closed schemes now have clarity that, where members retain a final salary link, relevant employers will not trigger an employer debt when they cease to employ those members.
- Good news for:
 - M&A
 - corporate restructurings
 - employers in multi-employer schemes with dwindling number of employees with a final salary link
- Section 75 debts can still be triggered in other ways.

British Airways Ltd v Airways Pension Scheme Trustee Ltd

Relevant background

- BA has one of largest overall pension deficits in FTSE 100 – around £3.5bn on an ongoing basis
- Pension increases under APS made by reference to RPI
- In 2010, Government announced that in future uprating of members' benefits from public sector schemes would be by reference to increases in CPI rather than RPI
- APS trustees introduced a new power giving themselves the ability to provide discretionary uprating of benefits in future years by such amount as they may determine
 - 2/3rds of Trustees needed to agree to this
- Provision was utilised by trustees in 2013
- BA challenged introduction of new power and the trustees' subsequent use of it

British Airways Ltd v Airways Pension Schemes Trustee Ltd

Rules

- Rules provided that main purpose of scheme was to provide pension benefits; no benevolent or compassionate payments could be made from the scheme
- Unilateral POA with a proviso preventing any change that would have the effect of changing the scheme's purpose
- Historically POA was subject to consent of Secretary of State

British Airways Ltd v Airways Pension Schemes Trustee Ltd

High Court decision

- At first instance Mr Justice Morgan held, in favour of the APS trustees, that:
 1. Introduction of power to make discretionary increases was not a breach of the power of amendment, or an abuse of trustees' powers, nor did it involve any element of unlawful 'pre-determination' by the trustees or any particular group of them.
 2. Subsequent exercise of that discretionary power by the trustees did not involve the making of a "benevolent or compassionate" payment, nor was the power exercised for an improper purpose.
- BA was given permission to appeal on the grounds that:
 - (i) discretionary increase breached the prohibition in APS rules on making "benevolent or compassionate" payments; and
 - (ii) the trustees, by assuming the role of "paymaster", had acted for an improper purpose.

British Airways Ltd v Airways Pension Schemes Trustee Ltd

Court of Appeal decision

- Court of Appeal did not consider that discretionary increases were “*benevolent or compassionate*” payments.
- Although motivation for granting increases may have included “*an element of generosity*”, this did not make them “*benevolent*”.
- However, the trustees had acted for an improper purpose when granting themselves power to make discretionary increases to members’ benefit.

British Airways Ltd v Airways Pension Schemes Trustee Ltd

Court of Appeal decision – Improper purpose

- The rules of the scheme state that “[the trustees] shall manage and administer the Scheme and shall have power to perform all acts incidental or conducive to such management and administration...”.
- This indicated that the trustees' purpose was to “manage and administer the scheme; not to design it”.
- Although the trustees had the benefit of a unilateral power of amendment, the majority found that the proper purpose of the power was not to allow the trustees to change the balance of powers under the APS.
- The trustees had wrongly assumed the role of a “paymaster” – setting rather than delivering the remuneration which BA pays to its former employees.

British Airways Ltd v Airways Pension Schemes Trustee Ltd

Implications

- Judgment confirms proper purpose principle
 - this can be used to invalidate use of power without having to show that exercise of power is out of scope
- Confirms that trustees' primary responsibility is to protect accrued rights and not to militate for higher benefits
- Confirms that sponsor is responsible for scheme design
- Judgment is important safeguard for sponsors against trustees who want to unilaterally grant additional benefits
- BUT trustees have decided to appeal

Northumbria Police Authority (Mr N PO-12763)

Background

- Mr N transferred DB pension worth £112k to London Quantum Scheme in August 2014
- Several 'red flags', including:
 - newly registered scheme and employer
 - sponsoring employer could not have employed member
 - unregulated introducer
- Authority failed to:
 - send member scorpion warning leaflet or warn member about risk of scams
 - check conditions for valid transfer were met
 - spot 'red flags' and raise concerns with member

Northumbria Police Authority (Mr N PO-12763)

Decision

- Authority required to reinstate member's pension
- Left for Authority to determine how this should be done
 - unclear whether Mr N should be treated as having ceased to be a member of the scheme or not
- Authority not able to rely upon statutory discharge as it failed to *“do what is needed to carry out what the member required”*

Northumbria Police Authority (Mr N PO-12763)

Implications

- Trustees / providers need to keep up with regulatory requirements and industry best practice regarding:
 - communicating and engaging with members regarding transfers
 - alerting members to risks of pension scams
 - conducting pre-transfer checks
- Was transfer effective or not?
- More broadly, concerns remain about availability and quality of advice on transfers
- Are pension transfers the next PPI?
- Who bears the risk on a buy-out?



ESG investing and new disclosure obligations

The temperature is rising

What we plan to cover

- ESG – In the news
- Background to ESG in OPS context
- Amendments to the OPS Investment Regulations 2005
- ESG Risks
 - Environmental
 - Governance
 - Social / Ethical
- Actions for trustees

ESG – Topical issue

- Environmental Audit Committee enquiry into Green Finance (concluded **May 2018**) and Environmental Governance (ongoing).
- ClientEarth writing to 14 UK pension funds threatening legal action if they fail to develop their approach to climate risk – **August 2018**.
- Potential member complaint to Pension Ombudsman if Shell UK Pension Scheme trustee does not disclose information on how it is addressing climate risk – **Reported in the FT, 7 October 2018**.
- Research indicating nearly 90% of the world's 100 largest public pension funds have not undergone formal assessment for exposure to climate-related risks – **Asset Owners Disclosure Project, 23 October 2018**.
- FCA and the Pensions Regulator have identified insufficient attention being paid to ESG considerations in investment decision-making as being a key area of concern which they will be seeking to address – **Joint Regulatory Strategy, October 2018**.



Background to ESG in OPS context

Background (1)

- Long established “prudent person” principle (*Learoyd v Whiteley* HL (1887) LR 12 App Cas 727)
- “best [financial] interests” test? (*Cowan v Scargill* 2 All ER 750 [1984], IORP Directive 2003/41/EC and OPS Investment Regs 2005)
- Trustees should take only relevant, and no irrelevant, matters into account when exercising powers (*Pitt v Holt* [2013] 2 AC 108)
- Regulation 2(3)(b)(vi) of OPS Investment Regs 2005 (SIP to set out “social, environmental or ethical considerations”)
- Section 172 of the Companies Act 2006 (directors duties applicable to corporate trustees “impact of the company's operations on the community and the environment”)
- The Kay Review of UK Equity Markets and Long-Term Decision Making, Final Report July 2012

Background (2)

- Law Commission Report (Law Com No. 350) “Fiduciary Duties of Investment Intermediaries” - 30 June 2014
- DWP Consultation – “Changes to the law on investments in occupational pension schemes” (27 February 2015 to 24 April 2015)
- IORP II Directive (EU) 2016/2341 – 14 December 2016 (comes into force 13 January 2019) – numerous ESG references
- Law Commission Report (Law Com No 374) “Pension Funds and Social Investment” 22 June 2017 – test for considering “non-financial factors”
- DWP Consultation – “Pension trustees: clarifying and strengthening investment duties” (18 June 2018 to 16 July 2018)
- Draft Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2018

Amendments to OPS Investment Regulations 2005

From 1 October 2019

- Update SIP to set out:
 - how they take account of **financially material considerations** over the appropriate time horizon of the investments, including how they are taken into account in selection, retention and realisation of investments;
 - the extent (if at all) to which **non-financial matters** are taken into account in the selection, retention and realisation of investments, and
 - policies in relation to the **exercise of voting rights** and undertaking **engagement activities**.
- **Financially material considerations** include (but are not limited to) environmental, social and governance considerations, including but not limited to climate change, which the trustees consider financially material.

Amendments to Investment Regulations 2005

- Schemes offering money purchase benefits must publish SIP on a publically accessible website and inform members of this

From 1 October 2020

- Schemes offering money purchase benefits must produce an implementation statement setting out what actions they have taken to implement investment policies
- Publish this online
- Significantly, trustees **not** required to take account of members' views

Environmental considerations



Environmental considerations

- Examples may include:
 - Climate change
 - Sustainability
 - Waste
 - Pollution
- Are these financially material?
- Amendments to Investment Regulations suggest that climate change is

Climate risk

- Financial risks associated with climate change include:
 - Physical risk
 - Transition risk
- What can trustees do about this?
 - Establish a policy
 - Understand how and to what extent their asset managers are assessing and monitoring these risks
 - Case study: HSBC DC Plan
- Risk of legal challenge growing if trustees fail to address this
 - ClientEarth's letter to 14 UK schemes
 - Threat of Ombudsman complaint against Shell UK Pension Scheme
 - Legal challenge against Australian pension fund

Corporate governance



Corporate governance

- Recent corporate failures show that this is a financial consideration
- New Corporate Governance Code applies from 1 January 2019
- Focus on:
 - long-term sustainability
 - corporate culture
 - engagement
 - board effectiveness
 - board composition
 - appropriate remuneration
- Stewardship Code promotes effective engagement by asset owners and asset managers on these issues

Social (& ethical) considerations



Social & ethical considerations



Social & ethical considerations

- Can be highly subjective and views change over time
- Are risks financially material?
- If not, trustees not required to take them into account
- But to what extent should trustees have regard to members' views?

Actions for trustees

1. Establish what new SIP and disclosure obligations apply (depending on size of scheme and nature of benefits).
2. Decide policy on ESG risks considering approach to different risks separately
 - climate change and corporate governance are clear financial risks to be considered
 - need to assess extent to which other environmental risks and social and ethical considerations are financially material
3. Decide extent to which (if any) they will take account of non-financial factors
 - Which factors? (e.g. reputation of the sponsor)
 - Will trustees take account of members' views? If so, how?

Actions for trustees

3. Need to understand how asset managers assess and monitor ESG risks (particularly if day-to-day investment power is delegated). Does the manager have an ESG policy of their own?
4. Decide how to reflect policy in mandates with asset managers
5. Decide how to monitor implementation of policy and the performance of asset managers
6. Record policy in SIP and, where relevant, post online

Questions

Comments

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