Wedlake Bell

THE PENSIONS COMPASS

FEBRUARY 2020

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INTRODUCTION

Welcome to our first 2020 Edition of Pensions Compass! As usual we have a fun packed edition to help blow away the winter doldrums.

Our first edition of Pensions Compass for 2020 includes the following articles:

- Clive's usual summary, in the form of the Ready Reckoner provides a go-to summary of the key developments in pensions law and governance over recent months;
- Justin has had his article on Winning the Pensions Endgame published in Pensions Today, you can access that article here *https://wedlakebell.com/winning-the-pensions-endgame/*;
- Paul has written an article on BT's further failed attempts to reduce its scheme's liabilities in respect of indexation following its case against HM Treasury;
- Wedlake Bell's Banking Team have written a very helpful article regarding the move away from LIBOR (this is not a pension-specific article, but we think it is a relevant issue for our readership);
- Olivia and Clive have considered some of the implications of the move away from LIBOR for DB Schemes and also consider the proposed changes to the Retail Prices Index (is it RIP for RPI?);
- I provide a reminder of the looming deadline for re-certification of existing PPF-compliant contingent assets and summarise how they can be of benefit for those schemes which do not have one in place.

We hope you enjoy this edition of the Pensions Compass. If you have questions regarding any of these topics please do get in touch.

For further details on these matters or any other pensions related queries, please contact a member of the Pensions and Employee Benefits team.

After a few years at the helm I will be handing over the mantle of Editor-in-Chief to Clive Weber prior to our next edition of Pensions Compass, due to be published in April 2020. I'm sure you'll all give Clive a warm welcome!

Alison Hills, Partner and Editor-in-Chief

PENSIONS READY RECKONER

Clive Weber, Partner, Pensions & Employee Benefits Team.
Please contact Clive with any queries on this Ready Reckoner.

PARLIAMENT		
Recent Legislation	**Date**	**Effect**
BREXIT – European Union (Withdrawal Agreement) Act 2020	24 January 2020	As of 31 January 2020, the UK ceased to be an EU Member State. However, during the implementation period to 31 December 2020 ("**IP**"), the UK continues to be treated by the EU as an EU Member State for many purposes including the jurisdiction of the Court of Justice of the European Union.
Statutory instruments made consequential on BREXIT	Various	To ensure relevant UK legislation continues to operate effectively during the IP and on its expiry if on 31 December 2020 there is no deal with the EU.
Trustees' relationship with their investment consultants and fiduciary managers – Governance and Registration Amendment Regulations	Regulations expected to come into force on 6 April 2020	These changes follow on from the Competition and Market Authority's ("**CMA**") review of the relationship between trustee boards and their appointed investment consultants and/or fiduciary managers. The new Regulations reflect the CMA Order. Subject to certain exemptions, trustee boards need to ensure they are legally compliant e.g. have set objectives for their investment consultants. Trustees will need in due course to report on whether they are compliant. In March 2020 Government is due to publish Guidance for trustees on climate control disclosure obligations as part of trustees' ESG policies.
Statements of Investment Principles (SIPs) – Regulations requiring additional disclosures	Investment and Disclosure Regulations made 3 June 2019	The Investment and Disclosure Regulations added new requirements for SIPs from 1 October 2019. Additional disclosures re trustees' relationship with asset managers, and trustees' publication of their latest SIP are required to be published on the scheme's website (by 1 October 2020 at the latest for DB schemes).
Opposite sex civil partners regulations	31 December 2020	Provides for individuals of opposite sex to form a civil partnership and to be treated in the same way as same sex couples in a civil partnership.

PARLIAMENT		
Proposed Legislation	**Date**	
Pension Schemes Bill 2020	Reintroduced in Parliament on 7 January 2020 Committee stage in House of Lords – 24 February 2020 and onwards	The Bill is expected to become law by July 2020. Main features include: (1) introduction of new financial penalties and criminal offences for persons recklessly dealing with DB schemes. See our December 2019 Pensions Compass article "Hot air, or real deterrent" ***https://wedlakebell.com/hot-air-or-real-deterrent/***; (2) introducing collective defined contribution schemes; (3) tightening provisions relating to statutory transfers; and (4) new requirements re the appointment of trustee chair and the chair's obligations including in relation to the scheme's funding strategy statement. Many amendments tabled for discussion during the House of Lords Committee stage.
Member Complaints – amending Regulations	Expected by 6 April 2020	Streamlining of member complaints to Pensions Ombudsman ("PO"), and guidance requests to the new financial guidance body (once established). Complaints to the PO intended for the PO's early resolution service will not be expected first to have been through the hoop of a scheme's internal dispute resolution procedure.
Finance Bill 2020	Royal Assent expected July 2020	A draft of the Finance Bill is expected to be published on Budget Day on 11 March 2020. Whether there are any changes to pensions tax remains to be seen.

FROM THE COURTS	
Topic	**Recent decisions**
Pension increases – whether permitted reduction *Britvic v Britvic Pensions* High Court, 17 January 2020	Yet another case turning on the specific wording of the scheme's pension increases Rule. The High Court decided that the cap expressed as RPI ("and any other rate") meant switching was possible only to a higher cap, and did not permit switching to a lower increase rate.
Unauthorised payments surcharge – SIPP member could not avoid the surcharge on the "just and reasonable" ground *Rowland v HMRC* First Tier Tax Tribunal ("**FTT**"), 7 January 2020	The SIPP member had entered into certain transactions indirectly involving his SIPP. This gave rise to "unauthorised payments" tax charges on the member. The member appealed against HMRC imposing the unauthorised payments surcharge, arguing it would be just and reasonable not to impose the surcharge. The FTT disagreed and held the surcharge was correct. (A more benign approach was reflected in *Hughes v HMRC* in 2019 where the facts were so complex that it would be unreasonable to impose the surcharge – the member's state of knowledge may be key in these cases).
Pension increases *Re Atos Pension Scheme* High Court, 27 January 2020	The use by the scheme of RPI was correct. The Court decided: (1) general index of retail prices index meant RPI; and (2) the words "where that index was not published" meant, in effect, ceased to exist.

FORTHCOMING COURT DECISIONS	
Topic	**Effect**
Contributions to SIPP – tax deductibility *Sippchoice v HMRC* Upper Tribunal tax, February 2020	The taxpayer paid his contributions by transfer of assets rather than cash. HMRC have challenged the tax deductibility of these payments.
Debt legislation: Section 75 debts in multi-employer schemes *PS Trustee v China Shipping* Court of Appeal, March 2020	How section 75 debts work in the context of segregated/non-segregated multi-employer schemes. On 5 February 2020 permission was refused to appeal to the Court of Appeal, so unless this is reversed the High Court decision will stand.
GMP sex equalisation *Lloyds Bank* High Court, April/May 2020	Hearing on further GMP sex equalisation aspects, notably regarding benefits transferred out of schemes.
Sex equalisation *Safeway v Newton* High Court, July 2020	The CJEU decided in October 2019 that EU law prevents levelling down benefits prior to scheme rules being formally amended save, exceptionally, on grounds such as where otherwise the financial position of the scheme would be seriously undermined – in the hearing in July 2020 the High Court will rule whether this is, or is not, the case in the circumstances of the Safeway Scheme.
Scheme amendments invalid? *Mitchells Pensions v Mitchells Plc* High Court, June 2020	Claim by trustee that scheme amendments made in 1996 incorrectly gave the employer power to decide the rate of pension increases and failed to preserve the trustee's power to select the relevant index for price indexes. Wedlake Bell comments: this case underlines the importance of accurate drafting.

FORTHCOMING COURT DECISIONS	
Topic	**Effect**
Inheritance tax on death benefits ("IHT") *HMRC v Parry (Staveley case)* Supreme Court, 31 October 2019	Supreme Court judgment awaited. The judgment will hopefully throw light on how the IHT legislation works in relation to transfers from defined benefit to defined contribution schemes – a popular move, sometimes aimed at wealth protection. Wedlake Bell's pension and private client teams have considerable expertise in this area.

THE ROAD AHEAD		
Topic	**Date**	**Effect**
TPR new code of practice on funding DB schemes	Draft expected Spring 2020	Likely to specify long term funding objective for schemes.
Government consultation on how to align the calculation methodology for the Retail Prices Index with the Consumer Prices Index including owner occupier housing costs	Consultation to open on 11 March 2020 (Budget Day) Government decision expected Autumn 2020	The change (if implemented as expected) is likely to take effect in the period 2025 to 2030. Those schemes with RPI linked member benefits may benefit, but this may be counteracted if the scheme's assets include RPI linked bonds. It is unclear how far the changes will automatically override scheme rules.
GMP sex equalisation	Limited HMRC guidance, February 2020	In addition to transfers out (see above under Forthcoming Court decisions), the tax treatment of payments to iron out GMP inequalities remains uncertain. Until full HMRC guidance appears, ironing out GMP inequalities will be difficult/impossible. On 20 February 2020 HMRC issued limited guidance – how far this assists will vary from scheme to scheme, please refer to us.

WINNING THE PENSIONS ENDGAME

2019 was a record year for UK pension scheme bulk buyouts. Total transactions exceeded £40bn.

As employers and trustees continue to work towards the *'pensions endgame'* by off-loading their defined benefit schemes to insurance companies, it is useful to take stock of some of the key legal issues facing all parties as they grapple with the 'ultimate' in liability management tools.

Traditional fully-insured buyouts

An insured buyout involves the trustees of an occupational pension scheme securing all the scheme's accrued benefits with an insurance company. This can involve two routes – the trustees: (i) buying individual annuity policies in the members' names; or (ii) buying a policy in their own name and subsequently transferring the benefit to members. The latter approach is known as a "buy-in" which eventually leads to a buyout.

Buyouts are usually carried out as part of the process of winding up the scheme. Once the annuities are in the names of the members, the trustees can proceed to wind-up and terminate the scheme thereby ending any further obligations to the members. Likewise, for sponsoring employers, this is usually the final step in achieving a 'clean break' from any further funding responsibilities towards the scheme. Some schemes will see this as the final destination in a scheme's funding flightpath or endgame.

In agreeing to take on the employer's responsibilities for paying out the members' pensions, the insurance company typically agrees to take a premium (i.e. top-up payment), together with the assets, such as bonds and shares, that back these liabilities. The insurers are essentially betting they will make more in investment returns than they pay out in pensions.

Issues to consider

Members' interests

Assuming the rules of the scheme in question permit the trustees to buyout members' benefits (if this is not the case, an amendment to the scheme's investment power may be necessary), trustees must only consent to a buyout if they believe it to be in the members' interests. The interests of members will usually be their financial interests. Generally, members whose benefits are being bought out will benefit from increased security – UK insurers are subject to capital solvency requirements and if they become insolvent, policyholders can seek compensation from the Financial Services Compensation Scheme. Before a buyout, members look to the sponsoring employer and in the event of an insolvency, the Pension Protection Fund.

Care should also be taken to identify those discretionary benefits under the scheme which will potentially be lost on buyout. Trustees would therefore be well advised to analyse the frequency with which such benefits are granted – it may mean hard-coding such benefits into the rules of the scheme which can obviously have a knock-on effect on pricing calculations.

Benefit specification

Trustees and their advisers will need to prepare a detailed benefit specification, setting out the benefits to be insured. This is usually required at the quotation stage and care must be taken to ensure that the correct rules are used to determine each member's benefits. This can be a particularly onerous task where schemes have a long history and different versions of rules are used to determine the benefits payable to different members and their dependants. It is not unusual for the benefit specification to form part of the negotiated buyout contract.

Data cleanse

The trustees and employer should also make sure that the scheme's data is as accurate and up to date as possible. Usually, insurers will want representations and warranties from the trustees on the accuracy of the data provided.

Where time, or indeed inadequate scheme records do not allow this, insurers may be willing to accept an additional premium to remove the scheme from the employer's balance sheet.

Provider due diligence

Selecting an insurance provider is primarily down to the trustees. Given that the insurer is to become the first port of call for members post-buyout, trustees need to be satisfied with (amongst other things):

- the provider's track record and reputation in the market;
- the provider's credit rating, geographical location and commitment to the market;
- administration and data protection systems in place;
- methods and quality of member communication;
- financial backing available in the event of a call on capital; and
- the price quoted: as trustees have a duty to consider the interests of the employer as well as the members.

Transfer and assignment

Having undertaken thorough due diligence on their chosen insurer, the trustees will generally be unwilling to allow flexible assignment or transfer provisions in relation to the buyout contract. The level of flexibility to allow the insurer to transfer within the insurer group and the effect of a change of control of the chosen insurer should also be carefully negotiated.

Equalising benefits for the effect of GMPs

The High Court decision in the Lloyds Bank case[1] confirmed that pension schemes containing guaranteed minimum pensions (GMPs) are obliged by law to equalise members' overall scheme benefits between men and women to take account of unequal GMPs. The decision also gave guidance about the most appropriate method for achieving this.

Before the Lloyds' decision, insurers had been willing to assume the risk of GMPs being equalised in the future, in return for an additional premium. Whilst the picture is now somewhat clearer following publication of GMP working group guidance, there is still uncertainty over which of the available equalisation methods is most appropriate. Until we have definitive guidance from the Government, this is an area that requires detailed advice albeit given the high levels of buyout activity over the last few years, insurers are obviously willing to assume a degree of risk.

Statutory discharge for trustees

For trustees to be discharged from their obligations to provide benefits once the buyout is complete, certain statutory requirements must be met. These include the statutory requirements regarding the preservation of benefits and protection of accrued contracted-out rights. Trustees will almost certainly be looking to their lawyers to provide comfort that these requirements have been met before the scheme is properly terminated and wound up.

Effecting a buyout is one of the most important milestones in a pension scheme's lifecycle. Legal, actuarial, investment and project management advice is key to ensuring smooth transition.

Justin McGilloway
Partner and Head of Pensions & Employee Benefits Team

1 [2018] EWHC 2839

DOUBLE TROUBLE FOR BT

BT v HM Treasury ("HMT")

The Court of Appeal has published its judgment in relation to the judicial review proceedings brought by BT against HMT. It is the second set of proceedings concerning the BT Pension Scheme ("**BTPS**") where the courts have found against BT. The other set relates to Section C of the BTPS where, last year, BT was refused permission to appeal the Court of Appeal's decision that RPI was still an appropriate measure of indexation for calculating pension increases.

In the latest judicial review proceedings, the Court of Appeal rejected BT's appeal against the dismissal of its claim for judicial review of HMT's direction that required the BTPS to pay full indexation of guaranteed minimum pensions ("**GMPs**") for pensioners reaching state pension age ("**SPA**") between 6 December 2018 and 5 April 2021. This is an unusual case because even though the BTPS is a private sector pension scheme, it was obliged to mirror HMT's direction for members of Section B of the BTPS under rule 10.2 of Section B, as if their pensions were payable under the Principal Civil Service Pension Scheme ("**PCSPS**"), which is a public sector pension scheme. BT estimate that will cost it around £120million which is something that is not required by BT's competitors in the private sector. To understand exactly why BT was faced with this liability under rule 10.2, we need to consider the legislative background to the indexation of GMPs and public sector schemes, BT's history and the specific circumstances surrounding the BTPS.

From 6 April 1988, GMPs in payment had to be increased by inflation, capped at 3% under what is known as a 'section 109 order' and (until April 2016) members with GMPs were entitled to have their additional state pension 'topped-up' if inflation exceeded 3%. Public sector pensions in payment have to be increased each year in line with a ministerial order, known as a 'section 59 order'. So as to avoid conferring a double benefit, GMPs are excluded from this order. However, when the additional state pension was abolished from April 2016, members with GMPs lost their right to the top-up mechanism. As an interim measure, for GMPs of pensioners reaching SPA between 6 April 2016 and 5 December 2018, HMT made a 'section 59A direction' so as to 'switch back on' the indexation of GMPs of public sector schemes (whilst excluding any increases made under a section 109 order to avoid double benefits) so members did not lose their right to full GMP indexation. In January 2018, HMT extended this to pensioners reaching SPA between 6 December 2018 and 5 April 2021, which BT challenged.

Next, we need to trace back through BT's history to a time when the Post Office used to provide telecommunications services. In 1969, the General Post Office was separated (including its telecommunications services) from a branch of the government's civil service to become instead a nationalised industry established as a public corporation. In 1981, the telecommunications business of the Post Office became a separate public corporation trading as British Telecom. In 1984, British Telecom was privatised and the assets and liabilities of the former public entity transferred to the new private entity which has been trading as BT since 1991. It follows that some of the members of the BTPS were former employees of the Post Office who received assurances about indexation when Section A of the BTPS was created in 1971 and also former civil servants who received assurances about indexation before the establishment of the Post Office in 1969.

Finally, we need to consider the particular facts of the BTPS, namely that there are three categories of members of the BTPS:

- Section A: members who joined before 1 December 1971;
- Section B: members who joined between 1 December 1971 and 31 March 1986 (or Section A or B members who left BT and re-joined after 31 March 1986) or members who elected to switch from Section A; and
- Section C: members who joined the Scheme on or from 1 April 1986 but before the BTPS closed on 31 March 2001 or members who have elected to switch from Section B.

Section A contained a materially identical rule to rule 10.2 of Section B, but in addition, Section A provided that benefits and indexation should mirror that which is payable to civil servants whereas Section B contained no similar qualification. There is no similar provision in Section C which was open to members following privatisation. Accordingly, it was BT's argument that the Section B rules do not mirror the PCSPS in the same way that Section A does.

HMT's decision in January 2018 was preceded by a consultation in which BT requested:

- A statutory override to provide private sector employers with a power to make amendments to pension scheme rules to remove any additional GMP increases payable as a result of the abolition of contracting-out; and
- An alternative means for implementing full indexation in public sector schemes, including an amendment or workaround to the rules governing the PCSPS specifically, rather than via legislation.

HMT rejected BT's requests and BT applied for judicial review of its decision. The High Court rejected BT's application on the grounds that HMT was entitled to make its decision, notwithstanding the effect on the BTPS.

BT appealed to the Court of Appeal submitting that, amongst other grounds, the High Court had erred in its fact finding for suggesting that BT had not presented the PCSPS amendment route as a stand-alone option, but had instead presented the statutory override as necessary for its proposals. The Court of Appeal rejected BT's appeal on the grounds that the High Court had not erred in its fact finding. In particular, if the amendment stood alone then complex legal issues remained as to whether pension increases under the PCSPS would be read across to the BTPS.

BT's history and origins from the civil service mean that this is a highly unusual case that is likely to have little impact on most private sector schemes. It is, however, a particularly interesting case and demonstrates how complex pension law can be.

Paul Ashcroft, Solicitor – Pensions & Employee Benefits Team

THE END OF LIBOR: A CALL TO ACTION!

LIBOR's farewell

A seismic change is taking place in the financial world. At the instigation of the Financial Regulators, the global markets are preparing to transition away from the London Interbank Offered Rate ("LIBOR") as the leading benchmark for short-term interest rates. This transformation has widespread implications across the global financial spectrum.

In this bulletin we summarise the background, timetable and immediate milestones around the transition away from LIBOR, what this means for corporates and other market participants, and what action they need to take to prepare for life after LIBOR.

What is LIBOR?

Since its inception in 1986, LIBOR has become the world's most widely-used benchmark for short-term interest rates. Around US $350 trillion in financial products are tied to LIBOR, which serves as the primary indicator for the average interest rate at which leading banks may obtain short-term loans in the London interbank market. LIBOR is quoted in five major currencies: U.S. dollar (USD), euro (EUR), pound sterling (GBP), Japanese yen (JPY), and Swiss franc (CHF).

Where is LIBOR used?

LIBOR is used in all manner of financial products, ranging from bilateral and syndicated loan facilities, bonds, hedging and derivative products, private placements and securitisations. It is also widely applied in other areas, including calculation of pension liabilities, discount rates applied to valuations, commercial contracts such as joint venture and project agreements, business purchase agreements, leasing and servicing contracts, intra-group loans and accounting and reporting disclosures in financial statements.

What is happening to LIBOR?

LIBOR's days are numbered: Following the "LIBOR scandal" and a consistent decline in the wholesale interbank lending market, there has been increasing regulatory pressure towards a transition away from LIBOR to alternative reference rates. In July 2017, Andrew Bailey, the head of the UK Financial Conduct Authority ("FCA") declared that the FCA would not compel or encourage banks to submit rates for the calculation of LIBOR after 2021. Further, he did not discount an earlier decline in the use of LIBOR.

Since then, the Bank of England and FCA have initiated an accelerated process to transition all financial products away from LIBOR and have set up task forces involving financial market stakeholders and professionals to expedite the process and to establish methodologies and processes for this purpose.

As a result, it is expected that LIBOR will cease to exist by the end of 2021, and critical milestones have been set for 2020 to achieve this. For example, the Regulators have encouraged the transition away from LIBOR of all sterling interest rate swaps from March 2020, and expressed the intent that new loans and other cash products issued after Q3 2020 which mature after 2021 will not reference LIBOR. All users of LIBOR need to prepare for this.

What will replace LIBOR? "Risk-free rates"

In response to the Regulators' concerns, working groups were initially established in each jurisdiction for the affected LIBOR currencies, and each working group recommended a so-called "risk-free rate" ("RFR") as its proposed alternative benchmark interest rate for LIBOR. In the case of sterling, the preferred risk-free rate is the Sterling Overnight Index Average ("SONIA") which is proposed to be the primary interest rate in the sterling markets.

STERLING OVERNIGHT INDEX AVERAGE was first launched in 1997 and is widely used in the derivatives market. Since April 2018 it has been administered and published by the Bank of England. It is an unsecured overnight rate based on eligible transactions reported to the Bank of England in the sterling money markets. It is considered to be a more robust interest rate benchmark than LIBOR because it is grounded in an active, liquid underlying market. However, STERLING OVERNIGHT INDEX AVERAGE and the other RFRs, which are backward-looking overnight rates, are not a "like-for-like" replacement for LIBOR (which is of course a forward-looking "term rate") and transitioning from LIBOR to RFRs is by no means straightforward.

How do RFRs differ from LIBOR and what does this mean for corporates?

RFRs operate very differently to LIBOR. In particular:-

- LIBOR is a forward-looking benchmark which is fixed in advance for a set interest period. This helps a borrower to manage its cashflow as it knows the rate with certainty at the start of the interest period. In contrast, RFRs are backward-looking overnight rates which are calculated daily and published the following business day at specified local times relevant to their currency jurisdiction. Therefore, in simple terms, the interest calculation using RFRs will only be known at the end of each interest period by way of averaging (or, more likely, compounding) each overnight daily rate, and this will clearly impact cashflow management. Although methodologies are being developed to provide a slightly earlier notification of the interest payment amount (typically five Business Days' notice), for certain borrowers STERLING OVERNIGHT INDEX AVERAGE compounded in arrears may not provide the necessary advance cashflow certainty, and for those borrowers an alternative rate (whether aligned to the Bank of England Base Rate, a fixed rate or a potential "term" STERLING OVERNIGHT INDEX AVERAGE rate) may need to be agreed.

- LIBOR (as a forward-looking rate) factors in a premium for "counterparty credit risk" as well as a "term" premium based on the length of the interest period. RFRs have no built-in credit risk or term premia because they are based on actual lending overnight in the wholesale markets, which is nearly risk-free. This means that RFRs are typically lower than LIBOR and methodologies must be established to "equalise" the economic effect as between counterparties switching existing ("legacy") contracts from LIBOR to SONIA, by way of a "credit adjustment spread".

Action Points for Corporates

In relation to existing contracts, transitioning from LIBOR will require amendments to all legacy loans, bonds, hedging, derivatives, commercial and corporate documentation currently referencing LIBOR. In addition, financial counterparties will need to ensure their treasury and back office systems are compatible with the application of compounded STERLING OVERNIGHT INDEX AVERAGE or other alternative rates. While the more commoditised derivatives market can adopt amending protocols under ISDA, the loan and other cash markets require amendments to each individual contract.
Given the breadth of the application of LIBOR and the accelerated milestones intended to significantly reduce the stock of LIBOR-based transactions this year, it is critical that corporates monitor developments, understand how RFRs differ from LIBOR and prepare themselves for the transition. Corporates must therefore:

- Establish where their LIBOR exposures are across all affected currencies.
- Check the terms of contracts which refer to LIBOR. Do they mature after the end of 2021? Do they provide "fallback" provisions setting out what will happen if LIBOR is not available?
- Understand RFRs and what these mean for their business and systems.
- Carry out an impact assessment of existing accounting hedges to gauge potential exposure on transition from LIBOR.
- Consider alternative reference rates (such as a fixed rate, Bank of England Base Rate or potential "term" STERLING OVERNIGHT INDEX AVERAGE rate) compatible with cashflow and calculation needs.
- Where amendments are being made for other reasons to existing contracts, consider including provisions which would make future benchmark-related amendments easier
- Engage with lenders and financial counterparties, professional advisers, regulators and industry groups in order to monitor developments and influence the outcome relevant to their contracts.

How Wedlake Bell can help

Wedlake Bell's Banking Team is closely monitoring market developments in this area and we have been participating in the Bank of England's Task Force focusing on transition away from LIBOR for existing cash market contracts. We are actively advising clients on this area across the banking and corporate market spectrum and we would be very pleased to provide guidance, advice or information on the status and implications for transition away from LIBOR insofar as it affects market participants, and how they should best prepare for the cessation of LIBOR.

Hilary Platt, Partner – Head of Banking Team
Clive Weber, Partner – Pensions & Employee Benefits Team

DB SCHEMES ABOLITION OF LIBOR AND (POSSIBLY)RPI

New Rules – Introduction

There is no shortage of challenges for trustees of defined benefit schemes and their sponsoring employers. In this article we consider two game changers, namely (1) the replacement of the London Interbank Offered Rate ("**LIBOR**"), and (2) the Government's proposal to alter the calculation basis for the Retail Prices Index ("**RPI**").

(1) LIBOR

LIBOR is used in many different types of financial contracts and for many decades has been the leading benchmark for short-term interest rates. It serves as the primary indicator for the average interest rate at which leading banks may obtain short-term loans in the London interbank market, and is quoted in five major currencies – US dollar, euro, pound sterling, Japanese yen and Swiss franc.

In the world of pensions, LIBOR-linked contracts such as trustees' derivative instruments, liability driven investment arrangements, buy-in/buy-out and longevity contracts often feature.

Why is LIBOR being discontinued?

Following the LIBOR 'rigging' sandal, and a consistent decline in the wholesale interbank lending market, there has been increasing pressure from international regulators to move away from LIBOR, with accelerated milestones in place for 2020.

Move to risk-free rates in place of LIBOR

As LIBOR is phased out across financial products it is being replaced predominantly by so-called "risk-free rates", which are based on actual, underlying overnight money market transactions as opposed to forward-looking "forecast" term rates which underpin LIBOR. For sterling, the preferred risk-free rate is the Sterling Overnight Index Average, otherwise known as "SONIA". Typically, SONIA rates will be lower than LIBOR rates as SONIA does not have built-in future risk or term premiums. Transitioning from LIBOR to SONIA means finding a methodology to equalise the economic effect between the parties – otherwise the switch is likely to involve winners and losers.

What should Trustee boards do?

Trustees should ensure that their appropriate professional advisers report on which of the trustees' contracts are linked to LIBOR. Advisers should make recommendations to the trustees about how the transition from LIBOR to SONIA should be managed. In the case of commoditised derivatives governed by terms set by the International Swaps and Derivatives Association ("**ISDA**"), ISDA standard amending protocols can be used but for other contracts, bespoke contractual amendments will be required.

Investment consultants and/or actuaries may be adept at identifying LIBOR-linked contracts. Trustee boards should, however, seek specialist legal advice on new bespoke contract wording to accommodate the transition from LIBOR to SONIA. Wedlake Bell's Banking Team are actively advising in this area, and participate in the Bank of England's task force focusing on the replacement of LIBOR. Please see the Wedlake Bell's Banking Team's recent article "THE END OF LIBOR: CALL TO ACTION" (available as part of the Pensions Compass February 2020). Please contact us if you need any advice in this area.

(2) Is it RIP for RPI?

Background

The Government's Consultation on its proposed change to the Retail Prices Index ("**RPI**") is due to be published on Budget Day, Wednesday 11 March 2020. RPI has been severely criticised and ceased to be an official National Statistic in 2013. Nonetheless, the Government continues to publish RPI as an index and there are a considerable number of RPI-linked gilts in issue.

Government proposal

The Government proposes to change the RPI calculation method so that, in effect, RPI will become more like CPIH (CPI with a housing component). This change would not be made until 2025 at the earliest.

The terms for gilts maturing after 2030 are set by the UK Statistics Authority and not by the Government. It seems likely that the UK Statistics Authority will in 2030 change the index for RPI-linked gilts maturing post-2030 to the new basis.

The Government has indicated that once it has considered the Consultation responses, it will take a final decision on its proposal later this year.

What is the impact on Schemes?

Actuaries are the experts here.

Broadly, asset values would decrease for schemes holding RPI-linked assets such as RPI-linked gilts. Conversely the value of member RPI-linked liabilities would decrease. However, the decrease in value of RPI-linked liabilities would not necessarily balance out the decrease in value of RPI-linked assets. Schemes with pension increases linked to CPI may still be holding RPI-linked gilts as there are so few bonds linked to CPI.

Trustees' legal responsibilities

The Government's proposals create major uncertainty. Trustee boards should take extra care where RPI is a component of their decision making, for example with regard to the valuation of member liabilities, management liability exercises and buy-in/buy-out contracts.

When making decisions trustees must ensure that they comply with the relevant legal requirements, including the requirement to obtain legal advice.

Switching from RPI to CPI

Some schemes with pension increases currently linked to RPI have been unable to link their pension increases to CPI instead, due to the wording of their scheme rules. If the changes to RPI proposed by the Government (from 2025 at the earliest) or by the UKSA (from 2030) come into force, this would remove the impetus for changes to the index from RPI to CPI, but at present there is no certainty about these changes or their timing.

The uncertainty may complicate current Court applications regarding RPI/CPI. Employers and Trustees considering changing from RPI to CPI should ensure that they obtain updated legal advice – the Wedlake Bell Pensions team has considerable practical experience in this area.

Latest RPI/CPI case

The proposed shift away from RPI may be somewhat galling for the trustees of the *Britvic* scheme. The case report in *Britvic*, heard in the High Court in January 2020, has recently been published. The Trustees persuaded the Court that the index for increases should continue to be capped RPI and that the Employer's discretion under the Rules was limited to setting higher, and not lower rates of increase – the discretion being "or any other rate decided by the Principal Employer", a surprising decision in our view.

So RIP for RPI it may be in the coming years, but not just yet. Meanwhile, it is still to be seen whether the courts will uphold arguments for amending scheme rules to replace RPI with CPI.

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CONTINGENT ASSET RECERTIFICATION DEADLINE LOOMS

Contingent assets can be of fantastic benefit to trustees and employers involved with defined benefit occupational pension schemes, particularly when cash is tight and employers wish to avoid the risk of over-funding a scheme.

On the one hand the trustees receive comfort in relation to the security being offered to them, and on the other hand the employer often benefits from a more flexible recovery plan/schedule of contributions. The contingent asset will only be triggered upon a certain event occurring, such as the insolvency of the sponsoring employer, or a failure by that employer to pay contributions due to the scheme.

Another benefit for all involved can be a reduction to the PPF levy payable in relation to the scheme.

Background to the PPF

The PPF is a lifeboat scheme set up under statute to support members (and their dependants) whose employers become insolvent and can no longer support their pension schemes. It is funded by way of a levy payable by defined benefit pension schemes which is broadly calculated by reference to the size of the deficit in the scheme and the risk of insolvency posed by the employer(s).

Where it is deemed that the Scheme is less underfunded as a result of taking the contingent asset into account the PPF rewards the parties for reducing the risk of the scheme entering the PPF by reducing the levy payment due. In order to benefit from this the security being provided must be:

- documented in a particular form (a PPF-compliant form) and comply with the PPF Rules in place for the year (the Rules are updated annually, usually in December); and
- registered and certified with the PPF by 31 March 2020.

PPF compliant security can fall into one of three different categories:
Type A: Guarantees from a parent or group company
Type B: Cash, UK real estate and securities
Type C: Letters of credit and bank guarantees

For any schemes which have:

- a sponsoring employer which is seeking to improve its cashflow by limiting its cash contributions to the scheme;
- a contingent asset which is not PPF compliant, but where the PPF levy is significant and there is interest in reducing future levies; or
- a PPF contingent asset

and a sponsoring employer which has assets over which it is prepared to offer the Trustees security, or a strong parent/group company we would urge you to consider whether putting a PPF levy in place would be of benefit.

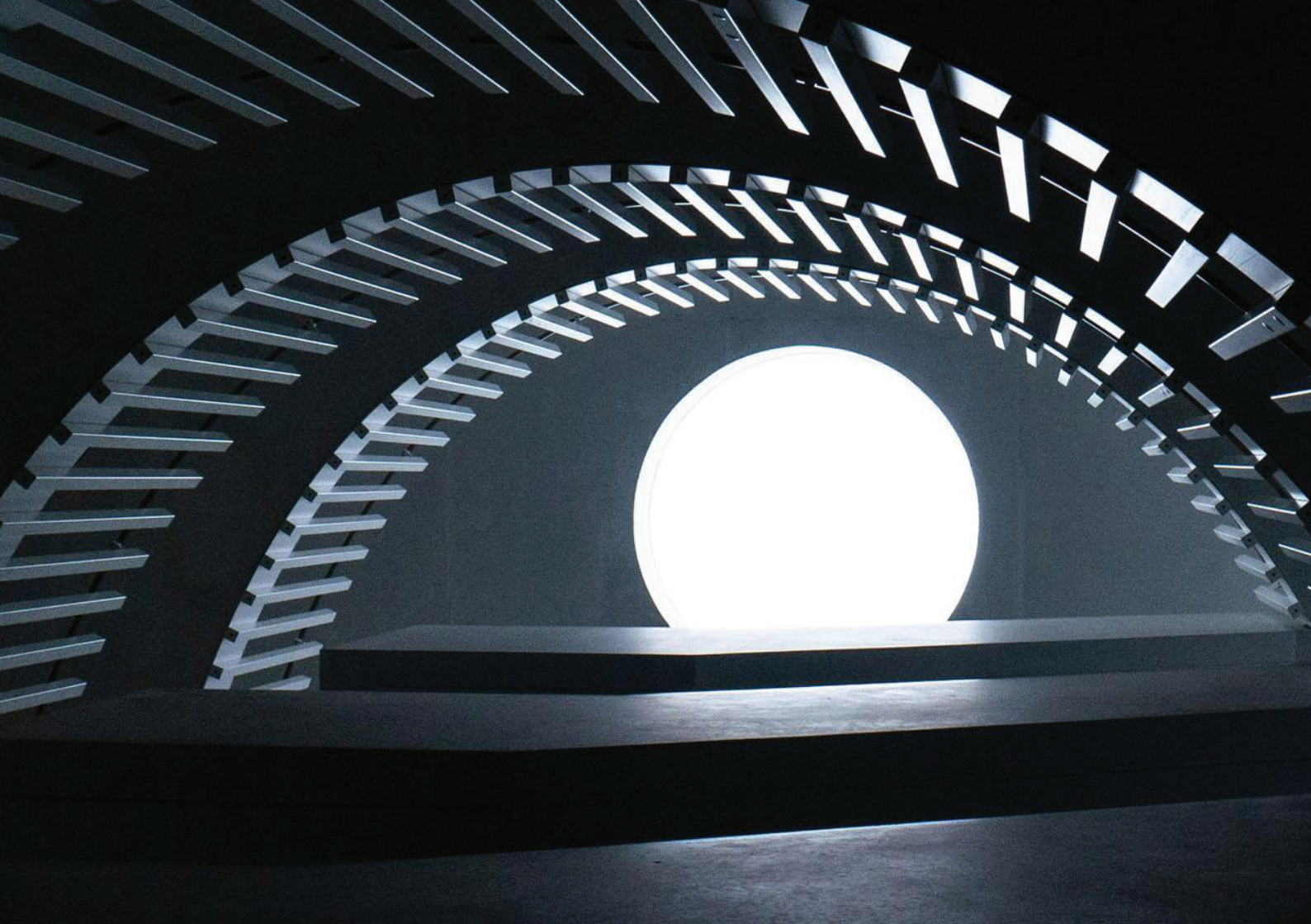
Indeed, NOW is the time to take action- the deadline for Trustees of DB occupational pension schemes to certify their PPF contingent asset(s) is **5pm on 31 March 2020**. Any attempts to set up a new contingent asset or recertify an existing PPF compliant contingent asset should be dealt with as a matter of urgency.

We are experts in this area and have guided many of our clients through the process, and prepared the necessary documentation. We also keep our clients updated with regards to any changes to the PPF's requirements, for example, last year saw the introduction of a new requirement for trustees to obtain a guarantor strength report from a professional adviser where the certification of a Type A group company would result in a levy saving of at least £100,000. Along with Wedlake Bell's expert Banking and Commercial Property teams we have helped many sponsoring employers save significant sums of money by putting in place:

- parent company guarantees;
- security over the offices owned by a group company;
- security over cash held in a separate account; and
- security over Escrow; and
- security over cheese (we joke not!) – this was an asset of the sponsoring employer.

If you'd like assistance with setting up a new contingent asset or ensuring an existing contingent asset is working as efficiently as it can for you please do get in touch.

Alison Hills, Partner – Pensions & Employee Benefits Team



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If you would like more information please contact any of the above or your usual team contact.

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