PMI

Defined Benefit Arrangements

STUDY MANUAL

PMI ACADEMY

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PMI's members, represented throughout the UK, are responsible for managing and advising some of the largest institutions in the world accounting for £1.3 trillion invested in pensions. We promote excellence through a range of services for the benefit of members, the wider economy and with over six million now saving as a result of automatic enrolment, society as a whole.

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Our Pathways offer five specialised streams: Retirement Provision, Pensions Administration Technical, Pensions Administration Practical, Pensions Trusteeship, and Pensions Benefits.

Further details on the units that comprise each Pathway and the work of the PMI canbe found on the website. We hope you will enjoy studying with the PMI and we welcome feedback you would like to offer. This feedback should be directed to the Qualifications Department at PMI: **pmiquali ications@pensions-pmi.org.uk**

Preface

This unit looks at the key aspects of defined benefit (DB) arrangements. Before we tell you more about the content, it is important to understand the context in which DB schemes operate today.

As more DB schemes close to new members and possibly to further accrual for existing members, or as they are wound up, defined contribution (DC) schemes are usually set up to replace them for future pension provision. As the number of DC schemes continues to grow, partly because of automatic enrolment, so has the need for pensions professionals with DC skills and knowledge, which is reflected by levels of recruitment, training and the development of DC tools and systems.

Whilst there may be no growth in the number of DB schemes as a vehicle for future pension provision, the combination of open or closed schemes (to either new members only or to both new members and future accrual for existing members) and schemes that are being wound up represents a very significant sector of pension provision that will continue to require professional and skilled management for some time to come. DB management skills are to some extent becoming less common than DC, yet they are very much in demand, particularly for a career that is not to be limited to working in the DC field.

This shift in the balance of skills and resources in the industry means that DB knowledge and expertise will continue to be valuable, both for pensions professionals and the industry and must, therefore, continue to be developed and supported.

This study manual explains the design, administration, taxation, governance, financing and winding up of DB schemes. It is divided into five Parts, with each subsequent Part building on the information in preceding Parts.

Part 1 looks at the fundamental elements of scheme design, the factors that affect the choice of design and the options available to employers where they need to control the costs of running the scheme.

Part 2 considers the issues that arise in the day-to-day administration of a DB scheme which, importantly, includes taking account of laws and regulations that trustees must comply with. We look at dealing with new entrants to the scheme, maintaining member data, providing benefits in respect of members on retirement or on death and dealing with members who leave the scheme before retirement.

Part 3 covers the taxation and governance of DB schemes, including the taxation of benefits paid to members, and the requirement for trustees to ensure that the scheme has the right governance framework in place to manage risks and run the scheme efficiently.

Part 4 looks at why and how DB schemes are funded, the actuarial principles that underpin the actuarial valuation of the scheme and the Statutory Funding Objective, introduced under the Pensions Act 2004. This Part also considers the factors that affect a scheme's investment strategy and how trustees establish and review their investment strategy.

Finally, Part 5 explains the role of the Pension Protection Fund (PPF), how the PPF is financed and the process a DB scheme may go through while winding up, from entry into a PPF assessment period to the securing of members' benefits and possible ultimate entry into the PPF itself.

Schemes that are registered with Her Majesty's Revenue & Customs (HMRC) enjoy a range of tax advantages but must comply with various requirements laid down by HMRC and legislation and may be subject to tax charges if they breach those requirements.

Until 6 April 2016, schemes were also able to contract out of the State Second Pension. Former contracted out schemes will still need to interact with HMRC's National Insurance Contributions & Employer Office (NIC&EO) over the next couple of years to resolve any outstanding contracting out matters and comply with the requirements for such schemes.

Throughout this study manual, HMRC's taxation requirements, and the requirements which apply to former contracted out schemes, will be a recurring theme because they determine many of the trustees' and administrator's responsibilities and are thus central to an understanding of DB schemes.

In addition, schemes are subject to a wide range of legislation, some of which is aimed directly at pension schemes (for example the Pension Schemes Act 2015) and some of which impacts on schemes in less obvious ways (such as the Marriage (Same Sex Couples) Act 2013). We will look at some of the relevant legislation within this study manual. While the study manual reflects the legislative position as of 6 April 2024, we will where appropriate also touch on changes that may take effect in the next few years. The world of DB schemes is continually changing, and schemes need to adapt to both legislative developments and changes in the economic environment.

Further new legislation, and changes to existing legislation, that will impact on DB schemes will continue to be introduced by the Government. In addition, the consequences of the UK's withdrawal from the European Union are also likely to have an (as yet unknown) impact on DB schemes. Students should, therefore, keep up to date with future developments as they occur.

On completing this study manual, you should understand the principles of the design, administration, financing and winding up of DB schemes and the issues faced by trustees, sponsoring employers and administrators.

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Syllabus

Aim:

To provide an in depth understanding of trust-based defined benefit (DB) arrangements, building on and utilising the knowledge gained in the core units and applying it in a variety of scenarios, recognising the requirements of different stakeholders.

1. **demonstrate an understanding of the factors which influenced defined benefit scheme design and the trend for new arrangements to be defined contribution schemes.**

Explain the impact of the following:

- employer needs
- employee needs
- legislation
- corporate activity
- State provision
- administrative considerations
- eligibility conditions, contractual enrolment and automatic enrolment
- design of contribution structures
- salary sacrifice and its application
- recent developments

2. **understand the different types of DB arrangements and current trends**

Analyse each of the following workplace arrangements:

- final salary (including cash balance)
- career average
- risk sharing schemes

Analyse individual and executive arrangements

3. **demonstrate an understanding of certain key features of the tax system that apply to defined benefit schemes**

Analyse the impact of the following

- tax relief on contributions and investment return
- authorised and unauthorised payments
- Annual Allowance, including Tapered Annual Allowance
- Lifetime Allowance
- The various protection regimes
- Benefit Crystallisation Events
- registration and deregistration
- scheme pays

4. **identify the roles of the employer and trustees**

Evaluate the importance of

- legal requirements
- good governanceand best practice including the voluntary "Code of Good Practice" on Incentive Exercises
- governance and impact on member outcomes

Evaluate each of the following

- selection, appointment, management, monitoring and review of advisers,delivery vehicles and providers

5. demonstrate an understanding of the impact of the abolition of contracting out

Explain the requirements for each of the following

- historic requirements
- changes to scheme design
- reporting requirements (leavers; retirements; solvency)
- GMP equalisation/reconciliation/conversion

6. describe the scheme level requirements for the administration of DB arrangements

Active, deferred and pensioner members:

- communication
  - disclosure
  - pension saving statements
- reconciliation procedures
- AVC options (not DC):
  - additional pensions
  - added years options on early leaving:
- refunds
- deferred benefits,
- transfers (out) including public sector restrictions retirement options:
- retirement
- ill-health retirement
- phased retirement
- flexible retirement
- lump sum options including trivial commutation
- open market option and different types of annuities death benefits:
- on death before and after retirement
- payment of lump sums and dependants' pensions
- record keeping

7. describe the scheme level requirements for the administration of defined contribution AVC arrangements

Explain the requirements for each of the following:

- objectives of defined contribution administration
- contribution and investment processing cycle
  - switching/redirection
  - charges
  - guarantees
- legislative requirements for membercontributions
- reconciliation procedures
- pension adviceallowance
- Statutory Money Purchase Illustrations
- rationalisation of AVCs

8. demonstrate an understanding of the legal requirements relating to the funding of registered pension schemes and the practical issues to which they can give rise

Describe and explain the principles of scheme financing

Outline scheme specific funding

Analyse funding objectives and measurement

Explain the following:

- financial and demographic assumptions
- calculations of contribution rates
- the treatment of types of asset and liability
- use of contingent assets
- setting factors for early/late retirement commutation, transfer factors
- the calculation of individual and group transfer values
- actuarial valuations and reports
- the role of the Pensions Regulator

Outline annual funding statements

Explain the significance of employer covenant

Define recovery plans and the schedule of contributions

Outline company accounting standards for pension schemes

9. identify and distinguish between different methods of actuarial funding

Analyse each of the following:

- projected unit method
- attained age method
- discontinuance
- Section 179 Pension Protection Fund basis
- accounting standards

10. describe what factors should be taken into account when determining a defined benefit fund's overall investment strategy

Analyse the impact of the following:

- size of scheme
- funding level
- strength of employer covenant
- role of regulation and legislation
- employer and trustee attitude to risk
- cash flowrequirements
- liability profile
- asset/liability modelling
- liability driven investment
- asset allocation
- risk management
- Statement of Investment Principles
- de-risking strategies

11. demonstrate an understanding of the approaches to managing risk, de risking and the advantages and disadvantages of each

Define and analyse the current approaches:

- buy in/buy out
- consolidation
- trivial commutation
- longevity swaps
- liability driven investment

12. demonstrate an understanding of the Pension Protection Fund (PPF) levy

Describe and explain

- the purpose of the PPF levy
- the calculation basis and issues arising

13. demonstrate an understanding of the stages of restructuring a defined benefit scheme

Analyse each of the following:

- reviewing benefit design
- changing future benefit or contribution structure
- closing to new entrants
- ceasing futureaccrual
- operating as a closed scheme
- winding up

14. describe the procedures to be adopted in connection with the winding up of a pension scheme and demonstrate an understanding of the powers and duties of trustees in such situations and related issues

Outline the interaction with the employer

Explain scheme termination

Define the procedure for wind up explain the issue of company insolvency outline the role of:

- Pension Protection Fund
- Financial Assistance Scheme

Describe discharging benefits on termination

15. describe the process to be followed for a pension scheme's journey into the Pension Protection Fund and demonstrate an understanding of the duties of trustees in such situations and related issues

Explain the stages in the process:

- Section 120 notice
- Section 143 valuation
- assessment period
- transition
- compensation
- entry to the PPF
- communication
- project management
- timescales

16. demonstrate an understanding of the challenges created by legacy issues

Describe and explain the following:

- administering legacyarrangements
- contracting out
- reporting requirements
- data standards
- resolution of data discrepancies
- pensions dashboard and record keeping

Part 1

SCHEME DESIGN

OVERVIEW

The Pension Protection Fund reported in 2022 that out of 6400, only 1013 defined benefit schemes (15%) are open to new members to accrue benefits. In 2019 the Pensions Regulator had reported that in 2001 that figure was 88%, that 41% of defined benefit schemes were closed to new members but existing members could still accrue benefits, and that 48% of defined benefit schemes were closed to new members and to future accrual for existing members (compared to 43% in 2016 and just 17% in 2010). There are more than 6 times as many Public Sector members in Defined Benefit/Hybrid schemes compared to the private sector.

78% of DB schemes surveyed operate on a 'final salary' basis, with a further 15% operating on a career average basis.

The expanding requirement on employers to automatically enrol employees into a pension scheme, and the introduction of defined contribution (DC) pension flexibility from April 2015, are important factors that are changing the future shape of pension provision. Other factors include the further reduction in the Lifetime Allowance and now its subsequent removal from 6/04/2024, prior to that the LTA charge was removed from 6 April 2023 and the introduction of a tapered Annual Allowance for higher earners from April 2016, as well as the introduction of the Lifetime Individual Savings Account (LISA) from April 2017

The Government also reformed the structure of the State pension scheme into the new State pension from April 2016, which included the abolition of contracting out. Further changes are already being considered: for example, the Government has already consulted on a green paper on the security and sustainability of DB pension schemes as well as the equalisation of Guaranteed Minimum Pensions (see Part 2, Chapter 2.5). In addition, the consequences of the 2019 general election, as well as the United Kingdom's withdrawal from the European Union, are also likely to have an (as yet unknown) impact on DB schemes. This illustrates the continuing need for DB schemes to respond to changes in the legislative requirements and other developments.

This Part of this study manual, which consists of just one chapter, looks at the nature of DB schemes and the various factors that currently influence the design of a scheme in terms of the benefits it provides.

After studying this Part, you should appreciate the need to control the overall cost of a DB scheme, the need to comply with relevant legislation and how important it is for a scheme to support the employer's business objectives as well as the members' needs.

Understanding the factors that impact on the design and management of a DB scheme is vital before we can move on to look at the day-to-day administration, which is the subject of Part 2.

CHAPTER 1

Understanding Scheme Design

INTRODUCTION

This chapter explains the features of a defined benefit (DB) scheme, the factors that affect the choice of scheme design and current developments in DB provision, including the implications of major pension and tax reforms.

All the above are vital to fully understand how these schemes are administered and financed. This chapter, therefore, forms the bedrock for the later Parts of this study manual.

1.1 THE FEATURES OF DEFINED BENEFIT SCHEMES

DB schemes are varied in their exact design, but they all have a number of common features. The benefit structure, together with the way in which tax and pensions law, regulations, codes of practice etc. must apply, will determine the benefits that can be paid to members. Compliance with the law is a fundamental part of scheme management and the administration of benefits and is therefore a key aspect of scheme design.

1.1.1 Definition of a Defined Benefit Scheme

A defined benefit scheme is a scheme that provides defined benefits. The Finance Act 2004 describes defined benefits in the following way:

"'Defined benefits', in relation to a member of a pension scheme, means benefits which are not money purchase benefits (but which are calculated by reference to earnings or service of the member or any other factor other than an amount available for their provision)."

DB schemes are often 'final salary', where the level of benefits paid is calculated by reference to the member's final pensionable salary and length of pensionable service with the employer. Career Average Revalued Earnings schemes (see Part 1, Chapter 1.1.3) are a common alternative to a final salary scheme.

The benefits under a DB arrangement may be funded by contributions from only the employer or from members as well. Although some schemes provide different rates of benefits depending on the rate of contributions paid by the member (see Part 2, Chapter 2.1.1) the benefits payable at retirement are not otherwise directly related to the contributions paid to the scheme. This is in contrast to a defined contribution (DC) scheme, where the benefits available at retirement depend directly on the value of the accumulated contributions paid by or in respect of the member.

Although the Finance Act 2004 defines DC schemes as including cash balance plans, the latter are in many ways DB in nature, so this study manual includes them.

1.1.2 Fundamental Design

The key features of a DB scheme are:

The Benefit Structure

The benefits are in the form of a pension defined in advance as a proportion of earnings that is calculated by length of pensionable service, for example for a final salary scheme this could be:

1/60 x Final Pensionable Salary x Pensionable Service = Pension

Members usually have the option to exchange part of their pension for a cash sum. This cash sum may be calculated by reference to pensionable salary and service but is often calculated as a percentage of the value of the pension.

In some schemes, such as current or former public sector schemes, the benefits are structured so that they are automatically a pension plus a cash sum.

There is a tangible link between earnings and the anticipated benefit, which is one of the attractions of DB schemes for employees. However, no monetary figure can be guaranteed in advance and the financial health of the scheme could affect the 'promised' benefit.

The Cost and Balance of Risk

The cost is met by regular contributions from either the employer only, or the employer and members. The scheme rules will usually specify who has responsibility for setting the contribution rate, which may be the employer or the trustees, or both, or even the scheme actuary. This will only be an estimate of the cost of the benefits, based on a number of assumptions, as future earnings and pensionable service cannot be predicted with certainty. It is likely that the funding rate will require regular adjustment. (See Part 4 for more information on scheme funding.) The contributions are pooled and invested but are not earmarked for individual members.

The employee knows the formula by which the benefit is defined, but the actual amount and payment are not guaranteed. The security of the pension depends on the employer's ability to finance the scheme at the correct level. The employer carries the risk of the unknown costs, but the employee also bears a risk in the event of underfunding or the employer's insolvency.

The employer can choose to continue a scheme unchanged, adjust the benefit design, buy out the liabilities, close or even wind up a scheme. A pension scheme is usually just one element of a benefits package offered by an employer, so the cost of running it naturally comes under review whenever the employer considers its finances.

In recent years the Government has introduced more protection for members by bringing in more regulation for employers and trustees to adhere to, designed to increase the security of funds and benefits, such as the Statutory Funding Objective (see Part 4, Chapter 3) and the Pension Protection Fund (see Part 5, Chapter 2). The Pension Protection Fund (PPF) is funded by a range of levies imposed on schemes that could be eligible for PPF compensation. The PPF Levy (see Part 5, Chapter 2) that each eligible scheme must pay is based on the degree of underfunding in that scheme and the associated risk that the scheme poses to the PPF.

1.1.3 Design Variations

Final Salary

This is traditionally the most common form of DB pension scheme.

A member's pension at retirement is calculated based on their pensionable service and their earnings close to retirement. For example:

1/60 x Final Pensionable Salary (FPS)
x Pensionable Service = Pension

A typical, if complex, example of FPS is: 'the average of your Pensionable Salary over any three consecutive years in the last thirteen years before you retire. Pensionable Salary is adjusted on each 6 April and means gross earnings, less any overtime earnings, in the previous tax year, before the deduction of your contribution to the Plan.'

Pensionable Service is usually counted from the date of joining the scheme, but if a member transfers benefits from another scheme and is granted additional service, then that is taken into account too. The term 'qualifying service' is also used.

Career Average Revalued Earnings Schemes

In today's variable and more flexible working environment, variable hours and fluctuating earnings patterns mean that the traditional final salary approach may no longer be appropriate. A Career Average Revalued Earnings (CARE) scheme could offer an alternative and a number of employers have switched to this design; however, many more are now switching to DC benefit provision (see Part 1, Chapter 1.4).

The benefits from CARE schemes are based on earnings over the member's entire pensionable service, matching fluctuations in earnings more closely. This method can enable employers to continue to offer a DB scheme but with the possibility of greater stability of cost.

To combat the effects of inflation, the earnings for each year are increased between the year in which they were earned and retirement. The increase may be in line with average earnings but can be in relation to another factor, such as price inflation. At retirement the pension is the total of the pension earned over each of the preceding years, based on the increased (or 'revalued') earnings. An example of how a CARE scheme works is given in Appendix A.

Hybrid Schemes

These are schemes where the benefits are neither pure DB nor pure DC and can be either:

- A scheme which primarily provides benefits on one basis but will provide them on another basis if that would produce better benefits

  An example of this is a scheme providing a DB pension promise whilst notional DC accounts are recorded for each member, with notional investment returns. If the value of the notional account would produce a better benefit than the DB promise, then the DC benefit will apply. This is commonly known as a DC underpin scheme.

The inclusion of a DB or a DC underpin makes the scheme more complex, and therefore more expensive, for the employer to operate (in terms of administration) than a pure DC or DB scheme or a scheme which provides both final salary and money purchase benefits. Examples include:

- transfers into a DB scheme may secure DC benefits
- additional voluntary contributions to a DB scheme may be paid on a DC basis
- schemes which offer members a choice between DB and DC sections

Cash Balance Schemes

Cash balance schemes from a member's perspective look like DC schemes because they provide an accumulation of contributions. The difference is that there is a guaranteed rate of return, and the target benefit is a cash sum at retirement that may be used to purchase a pension. The method and terms of conversion from cash to pension may be defined or may depend on annuity rates available.

The options for the payment of DC benefits on retirement, introduced from 6 April 2015 under pension flexibility, also apply to cash balance schemes.

Unlike true DC schemes, the contributions and funds are pooled and individual 'member accounts' are hypothetical. This, coupled with the fact that the annual rate of return is not necessarily the true return on the underlying assets, makes them closer to DB in nature. The risk of funding rests with the employer.

Shared Risk Schemes

In its November 2012 paper 'Reinvigorating workplace pensions', the Government coined the term 'defined ambition schemes'. This expression encompassed a range of scheme designs but with a common theme that (unlike a pure DB scheme) the risk of funding is spread between the employer and the members whilst (unlike a pure DC scheme) there is some certainty for members as to the final value of their pension pot.

The Pension Schemes Act 2015 provides for the introduction of shared risk schemes (the new term for what was referred to as 'defined ambition'). For the purposes of the Pension Schemes Act 2015, there are three possible categories of pension scheme:

- defined contribution schemes – where there is no promise at all as to the level of retirement benefits that will be provided to members
- defined benefit schemes – where there is a full promise as to the level of retirement benefits that will be provided to members
- shared risk schemes – where there is a partial promise as to the level of retirement benefits that will be provided to members

A possible example of a shared risk scheme would be a scheme that promises a core level of benefits with additional benefits above this level being discretionary, depending on the funding position of the scheme. Some hybrid scheme designs (for example schemes that provide a DB or DC underpin) already provide many of the key features of a shared risk scheme.

On 11 February 2021, The Pension Schemes Act 2021 was given royal assent. Collective money purchase schemes (CMPs) are a new type of scheme established by the Act. Sometimes known as a 'shared risk' scheme, CMPs are similar to defined contribution schemes as the member pays contributions into the scheme and will receive a pension benefit based on the value of the pension pot. The Occupational Pension Schemes (Collective Money Purchase Schemes) Regulations 2021 came into force on 1 August 2022. Legislation to enable single or connected employer collective money purchase schemes to apply for TPR authorisation.

Unlike defined contribution schemes, each member of a CMP will own a proportionate share of the scheme's collective assets, rather than just their own individual share. This means the risk is shared with all scheme members, rather than the risk lying with each individual member. This also means that CMP scheme trustees may employ higher-risk investment strategies as each member's benefit will be paid from the fund, rather than their own individual pot. In reality, the benefit a member receives in retirement may fluctuate as the fund's assets fluctuate.

CMPs offer a greater degree of flexibility and, according to the Government's CMP Impact assessment, may potentially deliver a higher level of pensions overall compared to the traditional defined contribution scheme.

For employers with staff in the Local Government Pension Scheme (LGPS) or the defined benefit structure of the Social Housing Pension Scheme (SHPS) who are looking to review their pensions strategy, the introduction of CMPs provides a further option.

1.1.4 Individual and Executive Pension Arrangements

So far in this manual, we have considered DB schemes in the context of an employer providing a scheme for a large number of employees – a 'group pension scheme'. It is also possible for a pension scheme to be established either for just one individual or for a small group of members, for example just for an employer's senior executives.

Such individual and executive pension arrangements are usually established on a DC rather than DB basis, although it is possible for them to be set up on a DB basis - particularly where the scheme is an Employer Financed Retirement Benefits Scheme (see below).

Executive Pension Plans

Executive Pension Plans (EPPs) were introduced in the early 1970s to provide enhanced pensions for directors and key executives, whose pension needs were different from the pension needs of other employees.

EPPs are almost exclusively established on a DC basis. They offer a large degree of employer discretion as to who joins, and the level of contributions paid in respect of each member. EPPs are registered pension schemes and, as such, members are subject to the Annual Allowance and Lifetime Allowance (see Part 3, Chapter 1) with any contributions in excess of the Annual Allowance and any benefits in excess of the Lifetime Allowance being subject to a tax charge.

As EPPs are almost always DC in nature and are often provided for high earning employees, members may also be subject to the Money Purchase Annual Allowance (see Part 3, Chapter 1.3.5) and / or the Tapered Annual Allowance (see Part 3, Chapter 1.3.2).

EPPs can be set up under a trust deed and rules, a master trust operated by a specialist provider or by an exchange of letters. The employer pays premiums into an insurance policy and benefits are provided to the members from the proceeds. EPPs can allow several members into one scheme under one set of documentation. Within the EPP, funds are earmarked for individual members.

Small Self-Administered Schemes

Small Self-Administered Schemes (SSASs) first emerged in the mid-1970s as a way for company directors to control their own pension investments.

SSASs differ from larger self-administered schemes in that such schemes are typically operated for the directors of smaller limited companies, where the scheme members are also the trustees. Until April 2006, the number of members of a SSAS had to be less than twelve.

These schemes provide the trustees with freedom over the choice and methods of investment and the ability to borrow and make loans, which can assist the company in its ongoing growth and development. Historically, Her Majesty's Revenue & Customs (HMRC) rigorously monitored such schemes due to a concern that they were being used for the enjoyment of the assets and tax relief, rather than for the purpose of retirement planning. Consequently, prior to 6 April 2006, all SSASs had to have a Pensioneer Trustee, who was approved by HMRC and acted as HMRC's watchdog. This requirement was, however, removed from 6 April 2006.

Since 6 April 2006, the legislative distinction between SSASs and other occupational pension schemes has fallen away. The term SSAS is, however, still often used to refer to a scheme established for either just one or a small number of members where all of the members are trustees of the scheme.

Employer Financed Retirement Benefits Schemes

Following the introduction of the 'Earnings Cap', which limited the amount of earnings that could be treated as pensionable under an 'approved pension scheme' where the member joined the scheme on or after a certain date (usually 1 June 1989), some employers established unapproved arrangements for their highly paid staff and directors. An 'approved scheme' was one that had been granted tax exempt status by the Inland Revenue (now HMRC) under the system that was in force prior to April 2006.

The idea here was that the members accrued benefits in the approved scheme on earnings up to the Earnings Cap and accrued benefits on earnings above the cap in the unapproved scheme. The unapproved scheme may have been funded in advance by regular contributions from the employer or may have been unfunded with the employer simply paying for the cost of the benefits as they fell due.

From 6 April 2006 the Earnings Cap was removed, however both the Annual Allowance, and the Lifetime Allowance (now removed – 6 April 2024 onwards) were introduced. The Annual Allowance continues to limit the tax advantaged savings and benefits that members can obtain from a registered pension scheme. As a consequence, there is still a role for former unapproved arrangements – which are now unregistered arrangements and referred to as Employer Financed Retirement Benefits Schemes (EFRBS).

1.2 WHAT AFFECTS THE CHOICE OF DESIGN?

Employer Objectives

The costs of running and funding a DB scheme, with the complex responsibilities for trustees and employers, have led to many DB schemes closing to new members or closing to both new membership and future benefit accrual for existing members. It is very rare now for employers to set up new DB schemes.

Scheme design issues in the context of this study manual are discussed not with new schemes in mind but for understanding existing schemes as part of an employer's responsibility and remuneration package, and possible reviews in future, for example looking at how future pension provision can be achieved on a sustainable basis.

Employers attract and retain their workforce with a salary and benefits package. If an employer wants to be competitive in the employment marketplace, an essential element of the total package is the pension scheme.

Since October 2012, employers (starting with the largest) have had to begin automatically enrolling their employees into a pension scheme that meets certain minimum standards. This requirement was gradually extended to organisations established from April 2012 onwards. Since October 2018 all employers will be required to offer workplace pension schemes to eligible employees. In deciding how to meet their new obligations, some employers will have reviewed the design of their DB scheme.

The Government has reviewed the auto-enrolment thresholds for 2024/25. The earnings trigger will remain at £10,000, the lower limit of the qualifying earnings band will remain at £6,240 and the upper limit of the qualifying earnings band will remain at £50,270.

The Pensions (Extension of Automatic Enrolment) (no. 2) Bill has passed the second reading and is now at the committee stage (July 2023). This Bill permits two extensions to Automatic Enrolment – abolishing the LEL for contributions and reducing the age for being automatically enrolled to 18 years old.

Examples of typical employers who have chosen DB schemes in the past are those:

- who are particularly concerned about staff security in retirement?
- in traditional industries who have, and want to retain, stable workforces
- who operate in marketplaces where staff expect DB schemes to be part of the benefits package?

A DB scheme will tend to suit a large, stable, or expanding business that has a workforce with a spread of ages and of a reasonable size. Generally, a DB scheme is not suitable for a small workforce, due to the effect on funding of changes in membership.

The company's total benefits package could influence the type of pension scheme in terms of whether it is DB, DC or a hybrid arrangement. For example, where a flexible benefits programme is operated, DC pension schemes are a more natural 'fit', whereas DB schemes can be more difficult to integrate.

The difficulty of designing a DB scheme that meets the needs of all members, particularly highly paid executives, and directors, has led some employers to introduce individual or executive arrangements, such as EFRBS and EPPs, specifically for certain groups of employees. The employer may be particularly keen to retain high-flying or key personnel and may wish to ensure that these individuals are provided with an overall benefit package that recognises their contribution to the business.

In some cases, particularly where an EFRBS is used, the individuals will accrue benefits within the employer's main pension scheme up to the maximum tax-efficient limits, with the EFRBS providing additional 'top up' benefits. In other cases, an entirely separate arrangement may be put in place offering a higher accrual rate or employer contribution rate than the main pension scheme.

Employee Expectations

A design that appeals to employees' needs and effective communication are vital. The value of a DB scheme as part of the overall benefits package offered by an employer becomes clear if employees can understand that State pension provision is unlikely to meet an individual's income needs in retirement.

Ensuring the employees appreciate the value of a DB scheme is important not only from an employee relations perspective, but also to attract and maintain a membership profile that will help to sustain the scheme. An employer must ensure that, when providing information about the scheme to employees, it adopts a communication style that is appropriate for the target audience and that will enhance the employees' appreciation of the benefits available from the scheme.

Employers cannot make it a condition of employment that employees join occupational pension schemes. Even after the employer is subject to the automatic enrolment requirements, employees can opt out of their employer's scheme, so scheme membership is still not compulsory. Some employers now operate contractual enrolment into a pension arrangement, so that membership of the scheme is provided for under the individual's contract of employment. Even in this situation, however, the individual can notify the employer that they do not wish to become a member of the scheme, so membership is still not compulsory.

This means that occupational schemes must be seen to be attractive to employees, otherwise employees may forgo the benefit of employer contributions and take out personal or stakeholder pensions - or do nothing and just rely on State provision and other personal savings.

One way of making a scheme attractive to a broad range of employees is to provide benefits that are 'targeted' to meet the needs of different groups of employees. An example would be a scheme offering a lower pension accrual rate but greater death benefits to younger employees who have families, while offering a higher pension accrual rate and lower death benefits to mature employees whose families have grown up. Such a choice can be offered through a flexible benefits scheme.

The most common employee needs are for:

- financial security in retirement
- protection of family and/or dependents in the event of death
- the actual security of the pension they expect

Where employees work variable hours (e.g., in the hospitality and retail sectors) the pension scheme design should take account of fluctuating pay patterns.

Costs

Undoubtedly a critical factor for employers is cost, both in terms of the payment of contributions and because any pension scheme deficit will appear on the company's balance sheet.

Pension and life assurance benefits are generally more expensive to provide as the member gets older. Ageing workforces will therefore be more expensive to provide for. The cost of a pension scheme extends beyond funding the scheme benefits. Employers must also allow for the costs of administration services, investment and actuarial advice, documentation and legal advice, audit fees, levies, communication and so on. Generally, the more complex the design, the higher the costs.

Employers can offset part of the cost of the scheme by requiring members to make a contribution. Some employers adopt a 'tiered' approach so that those who gain most from the company contributions will be those most willing to contribute themselves, e.g., by offering the choice of 60ths of final pensionable salary for 7% contributions or 80ths for 5% contributions.

Taxation: HMRC Rules

Before 6 April 2006, to benefit from various tax concessions, schemes had to be approved by the (then) Inland Revenue, now known as HMRC. To maintain approval the contributions and benefits had to comply with certain maximum limits set by the Revenue, so schemes were designed to restrict benefits to these maximum limits.

From 6 April 2006, often known as A-Day, this system was replaced with an allowance system. Schemes now have to register with HMRC and comply with the rules laid down in the Finance Act 2004 and the Pensions Tax Manual, formerly the Registered Pension Schemes Manual.

The former limits were not compulsorily removed by the Finance Act 2004, and many schemes chose to retain them on the basis of cost - removing the limits would have increased liabilities. For this reason, the traditional benefit structure reflecting the pre-6 April 2006 limits often remains as a legacy of former Inland Revenue rules, whilst post 5 April 2006 requirements apply for determining the tax status of those benefits.

TUPE Regulations

When a business is sold, most liabilities of the seller in respect of its employees pass to the buyer under the Transfer of Undertakings (Protection of Employment) Regulations 2006/246 (the TUPE Regulations). the Transfer of Employment (Pension Protection) Regulations 2005/649, where individuals are transferred to a new employer under TUPE and they had pension rights under an occupational pension scheme, the new employer must offer membership of an occupational pension scheme or stakeholder pension scheme. Where the new employer offers membership of a scheme that is not a money purchase scheme, that scheme must meet certain minimum quality standards.

It must either:

- provide benefits that are worth the equivalent of at least 6% of pensionable pay for each year of membership, excluding any benefits arising from member contributions, and must not require members to contribute more than 6% of pensionable pay, or
- require the employer to match any employee contributions paid to the scheme, up to a maximum of 6% of the employee's remuneration

Administrative Considerations

In addition to meeting the needs and expectations of the employer and employees, taking account of legislative requirements and being affordable, any pension scheme design has to be practical. A scheme will be of no real value if it cannot be efficiently and accurately administered.

If a scheme will be administered in-house, the design should take account of the employer's HR, finance, payroll functions, computer systems and the calibre of staff resources attached to pensions and benefits. If a scheme is administered by a third party, the charges levied by that third party administrator will to some extent reflect the complexity of the scheme design.

Not only will a highly complicated scheme design be more difficult to administer and, as a result, more likely to lead to errors in the calculation of benefits, it will also be more difficult to explain to members and prospective members. If an employee cannot understand the benefits they should expect to receive from a scheme, they are less likely to join or remain a member of that scheme.

1.2.1 Previous State Provision and Contracting Out

Until 5 April 2016, the State pension consisted of two tiers, the basic State pension, and the additional State pension, known as the State Second Pension or S2P.This additional pension, broadly speaking, provided benefits at a level determined by the earnings level of the employee. The basic State pension and S2P continue to be payable to individuals who reached State pension age before 6 April 2016.

An employer could take over responsibility from the State for providing the additional State pension for some or all of its employees. Both the employer and the employee paid a lower rate of National Insurance (NI) contribution to the State and the employer used the rebate to help fund benefits in the scheme. This was known as 'contracting out'. For a scheme to contract out, it had to provide benefits that were broadly at least as good as those that would be available under the 'Reference Scheme' specified in the Pension Schemes Act 1993. Schemes that did provide at least these minimum benefits were sometimes described as passing the reference scheme test (RST) and the minimum benefits required to pass this test were therefore often referred to as being RST benefits.

The RST only applied to benefits accrued from 6 April 1997. Prior to that date, a scheme could contract out on the basis of providing a Guaranteed Minimum Pension (GMP) which is a benefit broadly similar to the additional State pension.

On reaching State pension age, the scheme member would receive his/her basic State pension from the Department for Work and Pensions (DWP), and a pension from the DB scheme that met contracting out conditions.

An example showing how contracting out affected the structure of benefits is provided in Appendix B.

Provisions in the Pensions Act 2007 and the Occupational Pension Schemes (Contracting out) (Amendment) Regulations 2009/846, which came into force on 6 April 2009, allow schemes to convert benefits which were accrued on a GMP basis up to 1997 to a new simplified basis. This GMP conversion is not compulsory, so trustees will be able to consider the advantages of conversion against the costs and effort involved.

Until now the conversion option has rarely been used, but if GMP equalisation becomes a requirement (see Part 2, Chapter 2.5) GMP conversion may become more popular as this will remove the need for ongoing equalisation checks once the GMP has been equalised.

Legislation on the conversion of Guaranteed Minimum Pensions received royal assent on 28 April 2022 – The Pension Schemes (Conversion of Guaranteed Minimum Pensions) Act 2022. It amends and clarifies the provisions of the Pension Schemes Act 1993 which allow occupational pension schemes to convert GMP into other schemes benefits. Briefly - clarity that conversion applies to survivors as well as earners. Ensuring that any money purchase benefits are not included in the actuarial calculation to convert GMPS. It removes the requirement for employer consent to GMP conversion and the requirement to notify HMRC of a conversion.

1.2.2 The New State Pension and the Cessation of Contracting Out

Following a consultation in 2011 on 'A State pension for the 21st century', the Government published a White Paper setting out wide-ranging reforms to the State pension system. Under the new system, the basic State pension and S2P were integrated into a single tier State pension, referred to as the new State pension. Legislation to introduce this change was contained in the Pensions Act 2014 and the new State pension applies to individuals reaching State pension age on or after 6 April 2016.

A consequence of the introduction of the new State pension was that contracting out was abolished from the same date. The cessation of contracting out means that employers and scheme members no longer benefit from the NI rebate and therefore have to pay higher NI contributions. For employers, this means that previously contracted out schemes have become more expensive to run unless they can offset this additional cost in some way. The additional cost could prompt some employers to close their DB scheme.

To combat this, the Pensions Act 2014 introduced an overriding power, available until 5 April 2021, for employers to amend previously contracted out scheme rules to reduce ongoing benefit accrual and/ or increase contributions paid by members to reflect the loss of the NI rebate. Employers are able to do this without requiring consent from the trustees, although they must consult with affected members. The value of any increase in contributions and reduction in benefit accrual must not exceed the increase in the employer's NI contributions and an actuary needs to certify to the employer that these requirements have been met before the employer can exercise the power.

Employers whose pension scheme benefits are integrated with the State pension may also need to consider how their scheme design may be affected by the change in the State pension.

Pension schemes which were contracted out before 6 April 2016 need to preserve existing entitlements to GMPs and benefits derived from contracted out service between 6 April 1997 and 5 April 2016, and legislation is in place to ensure this happens. It is particularly important that contracted out schemes resolve any data discrepancies and fully reconcile their GMP liabilities, to avoid any possible issues or disputes in the future. This is because, since 6 April 2016, HMRC no longer tracks the movement of any contracted-out rights (for example, where contracted out benefits are transferred from one scheme to another) and HMRC has ceased sending statements confirming GMP liabilities to either schemes or members.

As a consequence of the abolition of contracting out, schemes are no longer required to notify HMRC when members leave pensionable service or transfer contracted out rights to another arrangement.

To help schemes reconcile their contracted-out liabilities in advance of the abolition of contracting out, HMRC introduced a reconciliation service which allowed schemes to reconcile their non-active scheme membership and GMP data, without the scheme having to have ceased contracting out first. Schemes had to register for this service by 5 April 2016 and reconciliation work is continuing. The reconciliation of active scheme membership and GMP data began in early 2017 and all reconciliation work (whether for active

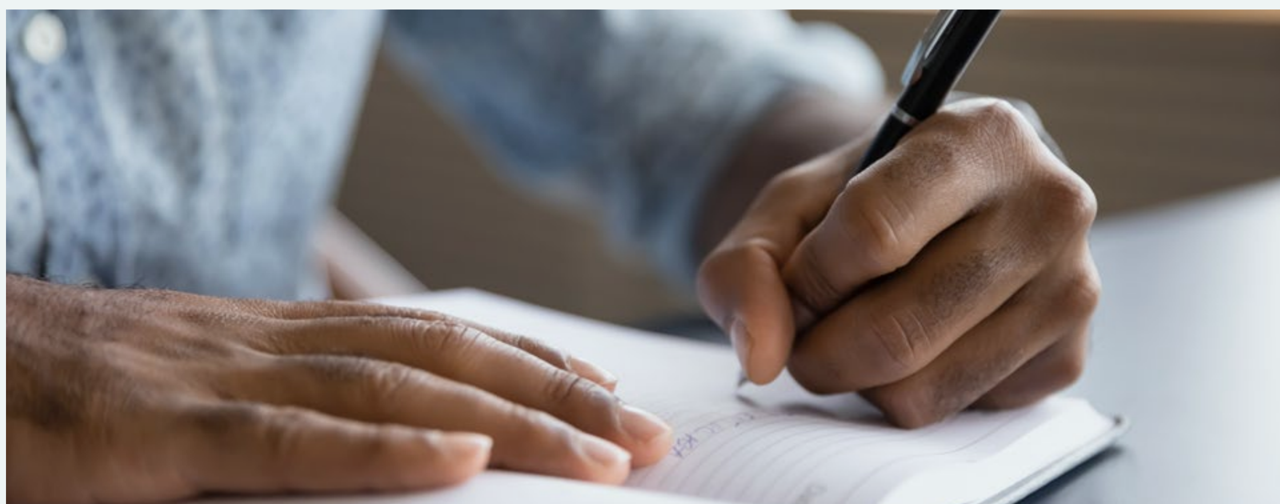
or non-active members) had to be completed by December 2018. Once scheme membership and GMP data has been reconciled, schemes must also undertake to rectify any benefits where the reconciled data differs from that previously held by the scheme.

1.2.3 Legislation

We have already mentioned the Finance Act 2004, former and current HMRC rules and the previous contracting out rules, on the basis that their influence has been fundamental to the design of DB schemes and their daily operation.

Other significant pieces of legislation include the Pensions Act 2004 (which introduced the Pensions Regulator and the Pension Protection Fund) and the Pensions Act 2008, which introduced automatic enrolment.

The last few years have seen further significant legislative changes to support developments such as the abolition of contracting out and the introduction of pension flexibility. Recent key Acts and a summary of their impact are detailed below. Further details of these changes are provided elsewhere in this study manual.



ACT	IMPACT
Finance Act 2011	• reduced the Annual Allowance from £255,000 to £50,000 • introduced the 'carry forward' of unused Annual Allowance for up to three tax years • introduced 'scheme pays' for cases where an individual's AnnualAllowance charge exceeds £2,000 • reduced the Lifetime Allowance from £1.8 million to £1.5 million • introduced Fixed Protection 2012 for members affected by the reduction in the Lifetime Allowance
Finance Act 2013	• further reduced the Lifetime Allowance from £1.5 million to £1.25 million • introduced Fixed Protection 2014 for members affected by the further reduction in the Lifetime Allowance • further reduced the Annual Allowance from £50,000 to £40,000
Pensions Act 2014	• provided for the abolition of contracting out and the introduction of the new State pension from April 2016
Finance Act 2014	• introduced Individual Protection 2014 for members affected by the further reduction in the Lifetime Allowance • introduced changes to the HMRC scheme registration process and a new 'fit and proper person' requirement for anyone wishing to establish a registered • pension scheme
Taxation of Pensions Act 2014	• introduced pension flexibility for members taking DC benefits • introduced the Money Purchase Annual Allowance for members who have flexibly accessed DC benefits
Pension Schemes Act 2015	• required members to take appropriate independent advice before transferring certain benefits to an arrangement that would allow them to access those benefits under the pension flexibility options • introduced changes to the circumstances in which members have a statutory • right to transfer their pension benefits
Finance (No 2) Act 2015	• aligned all Pension Input Periods with the tax year from 6 April 2016 • introduced the Tapered Annual Allowance for high earners
Finance Act 2016	• further reduced the Lifetime Allowance from £1.25 million to £1 million • introduced Fixed Protection 2016 and Individual Protection 2016 for members affected by the further reduction in the Lifetime Allowance
Pension Schemes Act 2017	• introduced provisions for master trusts providing money purchase benefits
Pension Schemes Act 2021	• introduced new duties relating to climate change and investments, defined benefit scheme funding, member transfer requests and pensions dashboard • strengthened TPR's regulatory powers including tough criminal sanctions and financial penalties for non-compliance
Finance Act 2022	• increases minimum pension age from 55 to 57 from 6 April 2028 • changes to timescales relating to the Annual Allowance charge
Finance Act 2023	• increased the Annual Allowance and Money Purchase Annual Allowance • removed the Lifetime Allowance charge
Finance Act 2024	• abolished the Lifetime Allowance • introduced Lump Sum Allowance, Lump Sum Death Benefit Allowance and Overseas Transfer Allowance

Pension Schemes Act 2021 measures include:

- Tougher Pensions Regulator powers and related criminal offences

  Two new criminal offences are also created with no limitation on who could be in scope. The threatof the new criminal offences may pose real challenges to decision making by company directors andwider stakeholders in businesses sponsoring DB schemes (including lenders and shareholders). Criminal penalties include unlimited fines and up to seven years in jail. The new contribution noticetests mean there will be the need for greater governance oversight and due diligence around dividend payments, refinancing and restructuring – by both company directors and by trustees

- Corporate activity

  There may be a need to consider mitigation to the pension scheme under a wider range of corporate activities. Trustees will need to be able to show that they have asked the right questions, considered the sponsor's response (with appropriate advice where relevant) and documented their 'reasonable' decision making process

- A tougher funding regime for DB schemes

  The new law requires trustees and sponsors to agree a long-term funding and investment strategy for a scheme. Trustees and sponsors will need to comply with new regime as they complete current valuations and review investment strategies and journey planning

- Climate change

  The Act provides for certain occupational pension schemes to address climate change risks and opportunities. Major new requirements for schemes over £1bn relating to addressing climate change risk. Significant action expected from trustees, including monitoring climate metrics quarterly and carrying out climate scenario analysis annually – liaison with sponsor CSR teams will often be helpful.Schemes in scope are required to publish annual reports setting out how they are managing climate related risks and opportunities – these public disclosures may also increase reputation risk

- Collective Money Purchase schemes introduced
- Help for trustees to prevent transfers where there seems to be a scam risk
- Some tidy up provisions for the Pension Protection Fund
- Pensions Dashboards delivery

Finance Act 2022 measures include:

- Increase to normal minimum pension age to 57 from 6 April 2028
- Extends the deadlines by which members can elect for their scheme to meet an annual allowancetax charge on their behalf (commonly known as "Scheme Pays ") where there has been aretrospective change of facts

The management of pension schemes is also subject to other laws which, directly or indirectly, address pension provision but arise from other areas of law, such as employment or social security. The UK has now the European Union (EU), but European regulations and directives may continue to impact on pension schemes.

New legislation or changes to existing law will involve at least a review of a pension scheme, which could lead to redesign. Changes to schemes may be limited to the minimum necessary to achieve compliance with the new law or they may go further.

The Finance Act 2023:

- removed the Lifetime Allowance charge
- increased the Annual Allowance and Money Purchase Annual Allowance to £60,000 and£10,000 respectively.

The Finance Act 2024

- abolished the Lifetime Allowance
- new Lump Sum Allowance, Lump Sum and Death Benefit Allowance, Overseas Transfer Allowance

1.3 DESIGN ELEMENTS

When reviewing scheme structure, whether it is to comply with regulations or to ensure benefits are affordable, these are the main areas that may need consideration:

1.3.1 Eligibility Conditions

The conditions for joining play a part in determining the characteristics of the membership profile, the flow of membership and the scheme's liabilities.

For example, removing a waiting period and allowing immediate entry can increase membership levels but may also lead to more small pensions having to be retained in the scheme. Restricting membership to certain categories of employees can help control costs.

Employers who intend to revise the eligibility conditions for their DB scheme will need to consider the automatic enrolment requirements. If the scheme is being used for automatic enrolment, the employer will need to ensure that the scheme's eligibility conditions are wide enough to allow automatic enrolment or provide an alternative scheme for those employees who cannot join the DB scheme.

1.3.2 Accrual Rate and Pensionable Salary

The higher the accrual rate (or fraction of salary) the larger the pension, e.g.:

PENSION	PENSIONABLE SALARY			FINAL PENSIONABLE SALARY		
1 / 60	X	20 years	X	£30,000	=	£10,000
1 / 70	X	20 years	X	£30,000`	=	£8,571

A Final Pensionable Salary definition which includes variable pay on top of basic salary will lead to higher benefits than one based on core salary only.

Either or both elements could be revised to provide higher or lower benefits for future accrual.

Some schemes have changed from a final salary basis to a CARE basis to manage costs. A CARE scheme also means that employees whose earnings do not continue to rise towards retirement still benefit from the earlier years when they earned more.

1.3.3 Contributions

Employers could look at the contributions structure. For example, if a scheme is non-contributory for members and funding is an issue, one possibility is to switch to a contributory basis and require members to pay a percentage of their pensionable salary e.g., 3%, 5%, 7%. The employer still pays the balance of the cost, but the overall cost is shared to a degree.

The rate may be fixed throughout the member's service or may increase with age to reflect the higher cost of providing benefits for older members. The Equality Act 2010 generally prohibits pension schemes from discriminating between members on the grounds of age. Under the Equality Act (Age Exceptions for Pension Schemes) Order 2010/2133, however, there are exemptions if the aim is to reflect the cost of providing the benefit and where the accrual rate is not age-related. Any employers who wish to amend their scheme's contribution structure will need to ensure that the new structure complies with these requirements.

Employers may also consider introducing a tiered contribution structure so that members can choose to pay a lower rate of contributions in exchange for a lower accrual rate or pay a higher rate in exchange for a higher rate of benefits.

This sort of contribution structure ensures that those who benefit most from the scheme pay more in and also gives members the flexibility to vary their contribution rate as their circumstances change. It does, however, make the scheme more complicated to administer.

1.3.4 Benefits and Options

Normal Retirement

Usually, a target age is set for benefits to be payable from the scheme, traditionally to tie in with retirement from service. The normal pension age (NPA) has typically been between age 60 and 65, although as State pension age increases, some employers may choose to increase their scheme's NPA. From 6 April 2028 the minimum retirement age increases to 57.

Since 1 October 2011 employers have not been able to automatically retire employees at a predetermined retirement age. Although this change did not require schemes to change their NPA or introduce a flexible retirement policy, it is important that the scheme is compatible with the sponsoring employer's retirement policy. Employers may, therefore, have reviewed their scheme to ensure that its definition of NPA remained appropriate and that the scheme supports the possibility that members will continue to work beyond this age.

Early Retirement

Schemes usually provide for voluntary early retirement before NPA or early retirement in the event of redundancy. This can support the employer's business policies and plans. For example, redundancy is supported by the pension being available early and enabling employees to choose to retire early can help succession planning. Where benefits are paid earlier than the NPA, they are usually reduced to reflect the longer period for which they are expected to be paid.

When early retirement is due to ill health, the pension calculation may include some or all of the member's prospective service to NPA and may or may not be reduced for early payment. When the Finance Act 2004 introduced new HMRC conditions for pensions payable on ill health, employers and trustees would have reviewed their terms and procedures.

Death Benefits

A recent example of legislation that may have led to a review of death benefits was the introduction of same sex marriages in England and Wales from 29 March 2014 under The Marriage (Same Sex Couples) Act 2013 and in Scotland from 16 December 2014 under The Marriage and Civil Partnership (Scotland) Act 2014. Under these Acts, schemes are required to provide survivors' benefits for surviving same sex partners, broadly to the same extent as for surviving civil partners.

Schemes must provide both surviving civil partners and same sex spouses with the same level of benefits as for surviving opposite sex spouses in respect of service from 5 December 2005. Schemes that were previously contracted out must also provide additional benefits for surviving civil partners and same sex spouses (see Part 2, Chapter 3.2.6).

Early Leaver Benefits

Whilst elements such as the accrual rate can be reviewed, there are statutory requirements which restrict the degree to which early leaver options can be revised.

One example is a change introduced by the Pensions Act 2004 for members leaving with between three months' and two years' pensionable service. Since 6 April 2006, they must also be offered the right to transfer their benefits to another scheme, if their only other option is a refund of contributions or no benefit at all.

Other examples of changes in legislation, that may have prompted schemes to review their benefit basis for early leavers, include.

- from 6 April 2009, the reduction in the statutory minimum rate of revaluation, from RPI up to 5% to RPI up to 2.5%
- from 1 January 2011, the change from basing this revaluation on increases in the RPI to increases in the CPI (see Part 2, Chapter 4.1.1)

There has been a reduction to the rate of GMP revaluation which applies under the fixed rate method from 3.5% per annum to 3.25% per annum, the new rate of 3.25% per annum came into effect from 6 April 2022. This rate is effective until 5/04/2027. The new rate will apply to contracted-out members who leave pensionable service on or after 6 April 2022.

Pension Increases

Pension increases help guard against pensions in payment devaluing due to inflation. Some statutory pension increases apply, the details of which are covered in Part 2, Chapter 3.1.8, and are linked to price inflation with an annual cap.

In a review of benefits, the statutory increases must be maintained and only those which are additional or discretionary can be amended.

Individual and Executive Arrangements

Where there are any individual or executive arrangements in place, the benefits available will depend on the nature of the specific arrangement and any provisions within the scheme rules, for example:

- most EPPs are established on a DC basis, in which case there are no statutory increases required for pensions in payment, although the scheme rules or contract wording may require increases to be provided
- as EFRBS are not registered pension schemes, there are no statutory increases required for pensions in payment, although the scheme may provide discretionary pension increases

1.4 CURRENT DEVELOPMENTS

There has been a continuing trend for employers with DB pension schemes to switch to DC for new joiners or close them to future accrual (as well as new members) and offer DC benefits for future service.

Although some employers remain committed to providing DB schemes, the financial reasons to switch to DC may be compelling. Pension scheme deficits now attract attention in the commercial world due to their impact on the value of a company's assets and can be the deal breaker in a corporate sale.

Increased scheme deficits and some recent high profile pension scheme failures have prompted the Government to seek suggestions on the best way to improve the management and oversight of the risks inherent in DB pensions, via its green paper entitled "Security and Sustainability in Defined Benefit Pension Schemes".

As mentioned in the introduction to this Part, only 4% of private sector DB schemes are still open to new entrants. The move away from DB benefit provision is likely to continue due to new developments, such as the introduction of pension flexibility from April 2015, which may increase the attractiveness of DC arrangements for members.

Employers sponsoring DB schemes are also looking for ways to limit their exposure to the open-ended costs associated with providing salary related pensions, a process known as de-risking. There are several options available for employers and trustees to reduce their risks, including pension increase exchanges, longevity swaps and enhanced transfer value offers, and new approaches to this problem continue to evolve. The various options available to employers to reduce their risk are discussed in more detail in Part 4, Chapter 6.

1.5 RESTRUCTURING

The true cost of providing defined benefits has become clearer now that scheme surpluses are the exception and scheme deficits are commonplace. The reasons for this are various and could be attributed to falling investment returns (against the liabilities to be matched) and additional costs imposed by legislation such as the levies imposed by the PPF (see Part 5, Chapter 2.6), as well as longer life expectancy.

To control the future costs of providing defined benefits, employers and trustees may look to restructure the way benefits are provided. When considering any restructuring, the employer and trustees should consult the actuary and legal adviser so that the impact of any changes on the expected future costs can be quantified and that any legal requirements are complied with. The employer and trustees should also be mindful of any known future legislative changes when considering any restructuring.

Options for restructuring

The main options for restructuring a scheme, depending on the severity of underfunding and how necessary it is to reduce costs, include:

- **Continue running a DB scheme** but reduce the benefit accrual for future service and/or increase members' contributions to share the cost of the scheme more equitably between the employer and members. For example, lowering the rate of future accrual from 1/60 to 1/80, raising the NPA or counting only basic salary as pensionable pay for future accrual
- **Close the scheme to new members** and set up a new DC arrangement, to limit the risk of open-ended costs for the employer to existing members only
- **Close the scheme to new entrants and to existing members** for future accrual but allow benefits for existing members earned up to the date of closure to be linked to future pensionable salary and offer both types of member entry to a new DC scheme.
  - Preventing future accrual has a greater impact on controlling funding than just excluding new members. This option usually needs an amendment to the scheme rules, which in turn is subject to both Sections 67 and 67I of the Pensions Act 1995 which basically prevent changes that worsen accrued rights
  - Close the scheme to all future accrual and wind it up. This option is most likely to apply when an employer becomes insolvent, in which case a new DC scheme may not be offered at all.

This is the most extreme option since any underfunding on winding up is far greater than on an ongoing basis (as explained in Part 4, Chapter 2.3), and it has to be addressed in the short term because benefits have to be secured in order to wind up the scheme.

Employers with 50 or more employees must consult with members and relevant parties such as recognised trade unions before making changes, so plans have to be carefully considered and the full implications understood.

Automatic Enrolment

The impact of the automatic enrolment requirements may also be a factor affecting any restructuring of an employer's pension arrangements.

If the employer's DB scheme provides a certain minimum level of benefits or the cost of future accrual is at least a certain minimum percentage of earnings, the employer can automatically enrol new employees into that DB scheme, otherwise the employer will need to automatically enrol their employees into a different scheme that does qualify.

The likely increase in the overall cost to the employer of providing pension benefits for all employees may also lead to some employers reducing the level of future benefit accrual to offset this extra cost.

1.6 PUBLIC SECTOR SCHEMES

We have been looking at private sector schemes so far, but a major provider of DB schemes is the public sector. These schemes are not immune to the impact of cost and new legislation.

There are schemes in the public sector that are established by trust deed and rules and are subject to changes in legislation in the same way as private sector schemes. There are also public service schemes, which need to be distinguished from other public sector schemes.

The terms of public service schemes are generally defined by statute. These schemes typically provide a good level of final salary benefits and, like DB schemes in the private sector, the costs of these schemes have risen sharply due to the same factors affecting DB schemes in general.

Following a review of the long-term affordability of public service schemes, the Government introduced a number of changes to existing public service pension provision, including:

- members of DB public service pension schemes have been moved to a new CARE scheme for future service
- NPA in the new scheme will generally increase in line with State pension age
- an employer cost cap applies, which is intended to limit some of the variations in employer contributions

Accordingly, new public service CARE schemes for civil servants, the judiciary, local government employees, teachers, health service workers, fire and rescue workers, members of police forces, and the armed forces were introduced under the Public Service Pensions Act 2013.This required that no new benefits could accrue under the main existing public service schemes for service after 31 March 2015 (or 31 March 2014 under the Local Government Pension Scheme in England and Wales). However, transitional protections may allow those closest to retirement to continue to accrue benefits under the existing schemes, and to retain their existing NPA. In addition, all benefits accrued up to the switch to the new CARE scheme are linked to members' final salaries at retirement.

The Government also changed the basis on which public service pensions increase in payment, from RPI linked increases to CPI linked, as an initial step towards controlling funding costs.

With the exception of the schemes for local government employees, the public service schemes are unfunded. When legislative or regulatory change is introduced for occupational pension schemes, separate or specific provision may also be made for public service schemes. Some key aspects of UK pensions legislation do not apply to the public service schemes, including, for example, the employer debt regime under Section 75 of the Pensions Act 1995, and the modification of subsisting rights provisions under Section 67 of the Pensions Act 1995.

There are also historical distinctions from the private sector, such as the 'Public Sector Transfer Club'. Many public sector schemes (and some private sector trust-based occupational schemes) participate in the 'Club', which is designed to ensure that when a member of one 'Club' scheme transfers benefits to another 'Club' scheme, the service credit granted by the receiving scheme is broadly equivalent to the member's service in the transferring scheme, irrespective of any change in earnings between the two employments. This enables employees who move from one public sector employer to another to transfer their benefits on beneficial terms and so promotes job mobility and recruitment within the public sector.

As a consequence of the introduction of pension flexibility from 6 April 2015, the Pension Schemes Act 2015 introduced restrictions prohibiting the transfer of benefits from unfunded public service DB schemes to arrangements that could provide flexible benefits. This arose from a concern that many members with accrued benefits in unfunded public service DB schemes might transfer their benefits to DC arrangements to take advantage of the new flexibilities, which would have a significant and adverse impact on public finances.

The existence of public sector schemes can also have a direct impact on private sector employers, particularly in light of the increasing trend for public sector employers to 'outsource' services to the private sector. Under the new 'Fair Deal' policy introduced in 2013, where employees are transferred from a public service employer to a private sector employer under TUPE, the transferred employees will normally retain membership of their existing public service scheme, with their new employer participating in that scheme.

Summary

DB schemes provide benefits that are not simply based on the value of a fund. Typically, the benefit is based on a member's earnings and period of scheme membership, either on a final salary or career average revalued earnings basis.

The scheme members will usually contribute to the scheme; however, the balance of the cost is borne by the employer.

There are many factors that influence the choice of scheme design, including the expectations of the employer and employees, the requirements imposed by HMRC and interaction with the State pension scheme. Employers and trustees may need to review their scheme design in light of legislative changes, to ensure that their scheme complies with any new requirements. An example is the introduction of the new State pension from April 2016 and the consequential abolition of contracting out.

Employers may need to restructure their scheme to control future costs. There is a range of options available to employers and each option will control costs to a different degree.

In some cases, employers may provide individual or executive pension arrangements for a small group of employees or directors to reflect the particular pension needs of these individuals.

Public service schemes are not immune from the need to adapt to changes in legislation and to control future costs.

Self Test Questions

- Explain the differences between the main types of DB scheme.
- Describe how a scheme's design could be structured to allow for the needs of members of different ages.
- Describe what changes an employer may make or have made to their DB scheme as a result of the cessation of contracting out.
- Outline the options available to employers and the trustees when restructuring a scheme to control future costs.
- Outline the possible reasons why a small employer might decide to close a DB scheme and move to a DC scheme instead.

Part 2

DAY TO DAY ADMINISTRATION

OVERVIEW

Trustees of an occupational pension scheme are responsible, amongst other things, for the efficient day to day administration of the scheme. To do this they must maintain comprehensive, good quality records for all members and ensure these are kept up to date, not only to ensure that benefits are administered correctly but also to satisfy legal and regulatory requirements. The Pensions Regulator sees record keeping as a priority and continues to monitor progress and focus its communication and plans on what schemes must do to achieve the expected outcomes – see Part 2, Chapter 1.3.

In almost all cases, the trustees delegate the administration. This is usually either to the sponsoring company through its in-house pensions department, or an external third-party administrator (e.g., a pension consultancy or insurance company).

The primary purpose of an occupational pension scheme is to provide benefits for members on retirement or death, so an understanding of the administration process required is central to understanding such schemes. The chapters within this Part take you through the key stages of a member's relationship with a scheme, from joining to the ultimate payment of benefits.

Chapter 1 considers the issues for new entrants. Chapter 2 considers active members, whilst Chapter 3 looks at both the legislative and practical aspects of retirements and deaths. In Chapter 4 we move on to the requirements for early leavers and the right of members to transfer out their benefits to other arrangements. At the end of this Part, students will gain an understanding of the membership process and the benefits payable in all circumstances.

Throughout this Part the HMRC requirements and, for former contracted out schemes, the contracting out requirements are key aspects as schemes must ensure they comply with all relevant conditions. A brief background to these is useful before discussing the day-to-day administration.

HMRC Requirements

Pension schemes which are registered with HMRC enjoy various tax advantages:

- tax relief is generally available on contributions paid into the scheme
- the money in the scheme largely builds up free of tax on any investment income earned
- some lump sum benefits can be paid tax-free

Since 6 April 2006 HMRC will only register a scheme (see Part 3, Chapter 1.1 for more information on the scheme registration process) if it complies with the conditions for registration set out in the Finance Act 2004 and in the Pensions Tax Manual (PTM), available at **Pensions Tax Manual - HMRC internal manual - GOV.UK (www.gov.uk)**

Under the post 5 April 2006 rules, HMRC has a system of allowances applying to contributions, benefit accrual and benefits paid. They are described in the PTM. In addition, only 'authorised payments' meet the conditions in the Finance Act 2004, so administrators must ensure that any payments they make comply with these rules.

Authorised payments include payments to members or to sponsoring employers. For example, pensions or cash sums payable to members on retirement, and authorised surplus payments or authorised loans payable to sponsoring employers. Any payment which does not meet the conditions for an authorised payment will be unauthorised and subject to tax charges on both the recipient and the scheme.

Scheme Administrator

HMRC requires each registered scheme to have an official 'Scheme Administrator' who is responsible for carrying out various duties relating to the scheme (such as payment of any tax due) in accordance with the Finance Act 2004. Normally the 'Scheme Administrator' will be the trustees.

The official 'Scheme Administrator' should not be confused with the person(s) responsible for day-to-day administration. In this study manual, where we are referring to the day-to-day administrator, we will use the term 'scheme administrator' or 'administrator' (i.e., all in lower case).

Contracting Out

Under the Pensions Act 2014, from 6 April 2016, a new State pension was introduced for individuals reaching State pension age on or after that date. From the same date, contracting out of the State scheme was abolished.

The National Insurance Contributions and Employer Office (NIC&EO), part of HMRC, deals with occupational pension schemes that were contracted out of the State Second Pension (S2P), although their operations are gradually winding down as residual work relating to contracting out is completed.

Until 6 April 2016 NIC&EO kept track of each employee's Guaranteed Minimum Pension (GMP) entitlement for pre-6 April 1997 service, and in particular who would be responsible for paying it when the individual reaches the GMP payment age (65 for men and 60 for women). Effective liaison between NIC&EO and pension scheme administrators was therefore vital.

From 6 April 2016, NIC&EO ceased tracking GMP entitlements as a result of the cessation of contracting out. They are currently dealing with any residual work arising from the cessation of contracting out, such as reconciling GMP entitlements and contracted out memberships with administrators of former contracted out schemes. From December 2018, NIC&EO will provide individuals with details of their contracted-out memberships.

The Government has consulted on the need for schemes to take account of inequalities in the GMP when determining whether the overall benefits provided are equal between the sexes – see Part 2, Chapter 2.5.

Between 6 April 1997 and 5 April 2016 DB schemes could contract out on the reference scheme test (RST) basis. Under the RST basis the scheme actuary had to certify that the scheme as a whole provided a minimum level of benefits when compared with a statutory reference scheme.

CHAPTER 1

New Entrants

INTRODUCTION

In this chapter we look at the processes and issues for new employees when they first join a pension scheme. This includes the requirement for employers to automatically enrol new employees, the joining process and the records that need to be kept once an employee joins a pension scheme.

Reliable member records are fundamental to the calculation and payment of the correct benefits, which are issues we will look at in later chapters of this Part. By the end of this chapter, you should understand the administration requirements for new entrants, which will enable you to put subsequent chapters into context.

1.1 APPLYING FOR MEMBERSHIP

1.1.1 Automatic Enrolment Schemes

Employers must generally automatically enrol all eligible jobholders who are not a member of a qualifying scheme into an automatic enrolment scheme from their automatic enrolment date. Importantly, the jobholder must not be required to provide information to join or remain a member of the scheme.

The requirement to automatically enrol all eligible jobholders excludes employees with enhanced protection, fixed protection 2012, fixed protection 2014 or fixed protection 2016 (see Part 3, Chapter 1.2.1 and 1.2.2). This is because an individual with any of these forms of protection would lose that protection if they joined a new pension scheme. There is also no requirement to automatically enrol eligible jobholders with primary protection, individual protection 2014 or individual protection 2016 as members with protected tax status are not the target audience for automatic enrolment.

1.1.2 Non-Automatic Enrolment Schemes

For non-automatic enrolment schemes, membership can be by application or automatic. Some companies may automatically enter employees into a non-automatic enrolment pension scheme when they first become eligible.

Whether or not an application form is used, employees will need to give some form of written authority for contributions to be deducted from their salary.

Often, this authority will be included as part of a contractual agreement between the employee and the employer – for example it may be included within the terms of the contract of employment. This is referred to as contractual enrolment.

The key difference between contractual enrolment and automatic enrolment is that under contractual enrolment the employer must get the employee's consent to put them into the pension scheme and to deduct any member contributions from their salary. Automatic enrolment does not require the employee's consent to enrol them into the scheme or to deduct any member contributions.

1.1.3 Membership Considerations

To comply with the Data Protection Act 1998, the trustees must inform new members of the purposes their personal data will be used for.

On joining a scheme members will generally be asked:

- to complete a nomination or expression of wish form detailing the person(s) to whom they would like the trustees to pay any lump sum death in service benefits, where these are payable under the trustees' discretionary powers
- whether they wish to pay additional voluntary contributions (AVCs) and if so, to complete a separate application form, which will include their investment choices if AVCs are on a defined contribution (DC) basis

On 25 May 2018 the General Data Protection Regulation (GDPR) replaced the previous EU Directive on Data Protection. The GDPR follows the broad principles set out in the Act, and many of the requirements are similar. However, the GDPR updates the regime in light of new technology, brings in some new requirements and makes some existing requirements more stringent.

1.2 VERIFICATION OF STATUS IN RESPECT OF NEW ENTRANTS

This also applies to active members if there is a relevant change in status.

1.2.1 Evidence of Age and Marital Status

Trustees/employers must obtain proof of age before benefits are put into payment.

Details of marital status and dependent children (where children's pensions are provided) must also be maintained during scheme membership as the spouse and any children are potential beneficiaries.

1.2.2 Evidence of Health

Where any death in service benefits (lump sum benefits and possibly spouses', dependants' and children's pensions) are insured, a substantial amount of cover (known as the 'free cover limit') is usually provided without evidence of health, provided the member is automatically enrolled or joins the pension scheme within the normal eligibility period and meets the normal eligibility conditions.

Where:

- a member joined the scheme outside the normal eligibility conditions, or
- admission is at the employer's discretion, or
- a member did not comply with an overriding condition of the insurer, for example that all employees joining the scheme must have been actively and continuously at work at their normal occupations for two months prior to the date of joining or, alternatively, be actively at work on the actual date of joining, or
- the member is re-joining the scheme having previously opted out the insurer is likely to require some evidence of health to be provided.

This might take the form of:

- completion of a health declaration by the member covering his/her personal and family medical history
- a report from the member's own doctor, or
- a medical examination by a doctor appointed by the insurer

If the evidence of health is unsatisfactory, the benefits that could be claimed from the insurer might be restricted or the risk might only be accepted on payment of a higher premium. The scheme's rules will determine the benefit payable on death in these circumstances and the benefit may or may not be restricted to the amount recoverable from the insurer. The member's record must be marked to ensure the correct benefits are paid in the event of death in service and to prompt reviews of any restrictions on the level of cover provided.

1.3 RECORD KEEPING

The Pensions Regulator requires all pension schemes to meet minimum record keeping standards as the regulator is concerned about the quality of data that is held. The regulator stresses that poor record keeping may lead to significant additional costs in a number of areas such as administration, error correction, claims from members, buy outs, winding up and, potentially, actuarial assumptions. To address these issues the regulator published guidance detailing its approach to the testing and measurement of data, particularly in relation to:

- common data – applicable to all schemes
- conditional data - dependent on scheme type, structure and system design
- numerical data - to aid understanding of the results

The regulator has stressed that simply measuring the presence or absence of data does not provide any evidence that the data is accurate and that schemes should assure themselves periodically that calculations are performed correctly.

The regulator will continue to review schemes' progress in this area and if it considers that further action is required, it may take enforcement action, using its statutory powers.

Summary

Employers who are subject to the automatic enrolment requirements must generally enrol all eligible jobholders who are not a member of a qualifying scheme into an automatic enrolment scheme from their automatic enrolment date.

Trustees must notify all new entrants of the purpose for which their data will be used, to comply with the GDPR.

Trustees need to obtain and verify details of each member's marital status and, in some cases, evidence of health. Where death in service benefits are insured and satisfactory evidence of health is not obtained, the benefits available may have to be restricted.

It is vital that all schemes maintain accurate and comprehensive records to ensure that benefits are calculated correctly and to comply with the record keeping requirements laid down by the Pensions Regulator.

Self Test Questions

- Explain why an employer would not be required to automatically enrol an employee with enhanced protection into an automatic enrolment scheme.
- Outline three circumstances where documentary evidence will be required from new members.
- Suggest two reasons why insurers may not insure death in service benefits without full evidence of health.

CHAPTER 2

Active Members

INTRODUCTION

In this chapter we look at the day-to-day administration of active members of DB schemes, including the payment of contributions by members, AVC administration, the possibility of transferring in benefits from other schemes, the updating of members' records and the need to provide active members with information about the benefits they are accruing.

An appreciation of the administration requirements for active members is central to understanding the overall administration of DB schemes because every member of the scheme will be or have been an active member at some stage.

Some DB schemes may also have a DC section providing DC benefits for some of the DB members. For such members the administrators of the DB section will need to liaise with the administrators of the DC section when settling members' benefits (for example on retirement). The study manual for Defined Contribution arrangements covers the administration of DC benefits.

After studying this chapter, you should understand the issues that arise in the day-to-day administration of active members, so that we can then move on to look at retirements and deaths in the next chapter.

2.1 CONTRIBUTIONS AND ADDITIONAL VOLUNTARY CONTRIBUTIONS (AVCS)

2.1.1 Contributions

Most DB schemes require members to make contributions to the scheme to share the cost of the benefits with the employer. The contributions are usually expressed as a percentage of pensionable pay.

Pensionable pay for contribution purposes is usually defined in the same way as the pensionable pay used to calculate benefits.

Where the scheme provides different rates of accrual for different categories of members, the contribution scales may be different, e.g., members whose benefits accrue at 80ths of pensionable pay may pay a 4% contribution rate whereas those whose benefits are accruing at 60ths may pay a 6% contribution rate.

Collection of Contributions

Various methods can apply. Some examples are:

- as part of the payroll process contributions are deducted from members' pay and paid to the trustee bank account (usually monthly) along with any employer contributions due
- where the overall contribution rate (employee and employer) is expressed as a percentage of the company's payroll, the employer will pay the set percentage to the trustee bank account once a month

Regulatory Timescale for Payment of Contributions

Regulations under the Pensions Act 1995 require that the employer must pay any employee contributions, including AVCs, to the trustees by

- the 22nd of the month following the month in which the contributions are deducted from members' pay, if the contributions are paid electronically
- the 19th of the following month if the contributions are paid by other means

Note that contributions must still be paid in line with the dates set out in the current schedule of contributions (see Part 4, Chapter 3.6), which must be no later than the dates above.

Late Payment of Contributions

Failure to pay contributions to the trustee bank account within the above timescales represents a breach of the regulations which, in some cases, may need to be reported to the Pensions Regulator. Trustees must check that both the correct amount of contributions is paid and that they are paid on time. Where, for example, a third-party administrator (TPA) maintains the bank account, trustees must agree with the TPA how the receipt of contributions will be monitored and who is responsible for ensuring that the correct amount is paid.

2.1.2 Salary Sacrifice

One recent trend has been the introduction of salary sacrifice arrangements, under which employees do not actually contribute directly to the pension scheme. Instead, they agree to forgo a percentage of their salary (normally equivalent to the scheme's contribution rate) and the employer pays this money to the scheme as part of the employer contribution.

The main advantage is that this delivers cost savings for both members and employers. Employee pension contributions, which are subject to National Insurance (NI), become employer pension contributions,

which are not subject to NI. Salary sacrifice therefore offers a low-cost way of increasing the efficiency of pension contributions – essentially a member can make the same contribution to his or her pension but with a smaller reduction in take home pay.

2.1.3 Additional Voluntary Contributions (AVCs)

Many schemes allow members to pay AVCs to supplement the pension they are building up under the scheme.

AVCs offer a method for members of an occupational pension scheme to top up their pension. AVCs are generally subject to lower charges than if the member began investing into a separate pension scheme and provide the member with the flexibility to stop or vary payments. Tax relief is also available on contributions, up to certain limits. As AVCs are attached to occupational pension schemes they are attractive as making the contributions is simple and they tend to be relatively cheap.

Features of AVC arrangements include:

- AVCs may be regular or one-off payments
- there is no statutory limit on the extra contributions which may be paid, although scheme rules could impose a limit. If a member's total contributions to the scheme exceed 100% of earnings, there is no tax relief on the excess
- the benefits payable from AVCs will depend on the scheme rules and trustee policy. Under the pension flexibility options introduced from 6 April 2015, in addition to allowing members to use their DC AVCs to take a pension (lifetime annuity, income drawdown or scheme pension, all with the option of taking cash as part of the benefits), schemes may also allow members to use their DC AVCs to take an uncrystallised funds pension lump sum (UFPLS) as an alternative or in addition to a pension (see Part 2, Chapter 3)
- prior to 6 April 2015, HMRC allowed the full value of AVCs to be taken in the form of cash at retirement provided this was no more than 25% of the value of the member's benefits that were being taken from all arrangements under the pension scheme. Special rules applied for certain members who commenced paying AVCs before 8 April 1987 and who could take their entire AVC fund as cash under the pre-6 April 2006 provisions. From 6 April 2015, schemes may allow the full value of any DC AVCs to be taken as a UFPLS or they may continue with their pre-6 April 2015 practice for allowing members to take their DC AVCs as cash

The Reasons for AVCs

Members may decide to pay AVCs for a variety of reasons, such as to plan for early retirement or if they have significant earnings that do not qualify for benefits under the main scheme (for example, bonuses and overtime payments). Members should be encouraged to think carefully when making decisions to commit extra money to AVCs, particularly DC AVCs, taking into account other alternatives and their own personal circumstances. For example, other arrangements may offer other pension flexibility options which the member's scheme does not provide in respect of DC AVCs and certain high earning members may be subject to a tax charge – the Annual Allowance charge – on AVCs paid, if those AVCs would take them over the Annual Allowance or the Tapered Annual Allowance. See Part 3, Chapter 1.3.1 and 1.3.2.

In Scheme AVCs or 'In House' AVCs

Schemes can offer DB and/or DC AVC arrangements, although DB AVC arrangements are becoming less common.

DB AVCs usually provide added years of pensionable service. For example, contributing an extra N% of pensionable pay for the expected remaining period of membership provides one added year. The value of N must be set by an actuary, since a low figure means that the scheme is subsidising the AVC payers and a high figure gives poor value for AVCs. Benefits are normally set up on the same basis as the main scheme's benefits. Records must show the contributions being paid and the added years purchased. On leaving service, transferring out, death or retirement, the added years must be included in the calculation of benefits.

DC AVCs are usually expressed as a cash fund in which contributions are invested until retirement. DC AVCs could also be invested in an Insurance Company with-profits policy or other type of policy. Such policies may provide a guaranteed annuity rate (GAR) to apply if the annuity is purchased with the provider of the policy. The level of the extra income depends on the investments chosen and, if an annuity is purchased, on the annuity rate (including the GAR if applicable) at which the fund is converted to pension. Again, details must be kept so that the benefits purchased can be taken into account in any benefit calculations.

Where the member is using their DC AVCs to provide a scheme pension, they must be offered a lifetime annuity as an alternative but the trustees do not have to give the member a choice as to the provider of the annuity, although it is expected that most schemes do this.

2.2 OBJECTIVES OF AVC ADMINISTRATION

2.2.1 DC AVCs

The objectives of DC AVC scheme administration are to ensure that:

- contributions are deducted from members' earnings in line with the member's instructions
- correct levels of contributions are paid to the pension scheme within the statutory timescales
- the contribution split between members and between AVC providers (where there is more than one AVC provider) is agreed
- correct contributions are invested with the AVC provider(s) in accordance with the members' investment choices in a timely fashion
- any changes (e.g., to the level of contribution, a change of provider or an investment switch) are dealt with in a timely manner in line with the member's instructions
- any disinvestments are actioned promptly
- where permitted by the scheme, members can use their AVCs to pay for the pension advice allowance
- the AVCs are included when the member's main scheme benefits are settled (the member can take the AVCs at a different time to their main scheme benefits if permitted under the scheme rules)

DC AVCs are sometimes remitted directly to the AVC provider to minimise delays in investment. As these transactions will not be recorded in the trustee bank account, the AVC provider's records will need to be obtained at the accounting period end to ensure the AVC figures are correctly included in the accounts.

From the members' perspective, the DC AVC administration process is straightforward. Contributions are paid into the pension scheme and are invested with the AVC provider, then at retirement, investments are realised and benefits secured.

From the scheme's perspective, there is a need to ensure that AVCs are invested in a timely manner and accurate records are kept to show which members have paid AVCs and which provider holds the AVCs. To ease administration, some schemes with a number of historical AVC arrangements have rationalised them so that the AVCs are now all held with one provider.

2.2.2 DB AVCs

The objectives of DB AVC administration are to ensure that:

- contributions are deducted from members' earnings in line with the member's instructions
- the correct levels of contributions are paid to the pension scheme within the statutory timescales
- the contribution split between members is agreed
- the member's benefits include allowance for the benefits secured by the DB AVCs (e.g., added years) when their benefits become payable

From the members' perspective, the DB AVC administration process is straightforward. Contributions are paid into the pension scheme to secure additional DB benefits at retirement.

From the scheme's perspective, there is a need wto ensure accurate records are kept to show which members have paid AVCs and the additional benefits to be provided by them.

2.3 AVCS – INVESTMENT PROCESSING AND CONTRIBUTION MONITORING

2.3.1 Investment Processing

The employer's payroll will collect DC AVCs from the member's pay and, unless the AVCs are remitted direct to the AVC provider, make payment to the trustee bank account operated by the scheme administrator, who will pay the AVCs to the AVC provider. A schedule of members and the AVCs paid for each member will be sent to the AVC provider so that they can allocate the AVCs to the member's individual account.

The employer's payroll will also deduct any DB AVCs from the member's pay and make payment to the trustee bank account. DB AVCs will then be available for investment in line with the scheme's investment policy as for other ordinary contributions, as the AVCs are held generally in the scheme as opposed to being held in individual investment accounts with an AVC provider.

2.3.2 Contribution Monitoring

The Pensions Regulator's Code of Practice 13 (Governance and administration of occupational trust-based pension schemes providing money purchase benefits) applies to AVCs in DB schemes.

In the administration section of the code under 'Core Financial Transactions' the regulator states that the law requires trustees to ensure that core financial transactions are processed promptly and accurately. Trustees will need to decide how to apply this and any other relevant aspects of the code to AVCs.

2.4 AVCS – DC GOVERNANCE - BAN ON MEMBER-BORNE COMMISSION

Effective from 6 April 2016, the Government introduced a ban on member-borne commission which applies to occupational pension schemes providing money purchase benefits and which are being used by an employer as a qualifying scheme for automatic enrolment purposes. This includes DC AVCs even if the AVCs are the only money purchase benefits provided under such schemes. In October 2017, the ban was extended to commission arrangements already in place prior to 6 April 2016.

2.5 EQUALISATION

In September 1994 the European Court of Justice ruled that schemes accepting transfer payments became responsible for any inequality in the transferring scheme's benefits for pensionable service in the transferring scheme on or after 17 May 1990, the date of the 'Barber Judgment' (Barber v. Guardian Royal Exchange Assurance Group (1990)).

In most cases the inequality relates to GMPs as it has never been clear whether or not they need to be equalised. Since the beginning of 2010 there have been various Government statements to the effect that schemes should take steps to eliminate differences in benefits resulting from unequal GMPs.

In early 2012, the Department for Work and Pensions (DWP) consulted on a possible method which schemes could adopt for GMP equalisation. However, following representations by respondents, the Government indicated that they would delay publishing anything further on this issue while they considered how GMP conversion could be used as part of the GMP equalisation process.

In late 2016, the DWP consulted on a new methodology which schemes could adopt for GMP equalisation. Following responses the Government stated that there were still many points to consider and further discussion would be undertaken with an industry working group. The Government also stated that interested parties would be notified once a more definite timescale for publishing guidance and amending legislation is known.

However, all pension schemes which will transfer into the Pension Protection Fund (PPF) must equalise their GMPs in line with the method required by the PPF.

2.6 TRANSFERS IN

A new or existing member may have deferred benefits from a previous employer's pension scheme (DB or DC) or individual arrangement such as a personal pension. Members may be able to transfer these deferred benefits into their new employer's scheme, although many schemes are no longer prepared to accept transfers. Where they do accept them, DB pension schemes will generally offer one of the following benefits in return for a transfer payment:

- added service credits
- additional pension
- a payment into a separate DC arrangement

To produce a quotation of benefits that would be provided in exchange for a transfer, the trustees of the receiving scheme need to be given certain information, such as the transfer value available and whether any contracted-out benefits are involved.

Under the disclosure regulations, a quotation of the benefits the member could receive from a transfer in must be provided within two months of the trustees receiving all the necessary information to calculate those benefits. The member will then be able to consider the additional benefits offered in the new scheme alongside the details of the benefits under the former scheme.

Few schemes have identical benefits or terms and conditions, so deciding whether or not to transfer benefits is not an exact science. Before a transfer is made the member must confirm that he/she appreciates the terms and conditions of both schemes, and the benefits afforded by the transfer value applied under the rules of the new scheme. If the member does not agree, the transfer does not take place and the member retains his/her deferred benefits in his/her old scheme.

2.7 TEMPORARY ABSENCE AND PART TIME WORKING

2.7.1 Temporary Absence

Members may be temporarily absent from work for long or short periods of time for a variety of reasons, such as:

- ill health
- family related leave e.g., maternity or paternity leave
- overseas secondments
- jury service or military service

The way different periods of temporary absence are treated will depend on the scheme rules and on legislation. Full records must be kept of the length of, and reasons for, the leave so that benefits can be calculated correctly.

2.7.2 Part Time Working

Where a member works part time, pensionable salary and pensionable service are generally converted into their full-time equivalents, as this permits the calculation of accurate pro rata benefits for the member compared with a full-time member on the same salary and will cope with the member switching from full time to part time service (or vice versa) or changing their part time hours. Full records must be kept of each period of part time service, including hours and salary details, so that the correct benefits can be calculated.

Lump sum death benefits based on a multiple of salary will generally be based on the actual part time salary at the date of death, although this will depend on the salary definition.

2.8 DATA REQUIREMENTS AND COMMUNICATION

2.8.1 Maintaining Data

As a minimum, when a record is first set up for a new member the following information will be required:

- full name
- sex
- date of birth and whether age has been admitted (i.e., whether suitable evidence of age has been seen by the scheme or employer)
- National Insurance number
- marital/civil partner status
- employing company and/or location
- postal address and postcode
- date of entry to company service
- date pensionable service started/date of joining scheme
- payroll number
- location/unit/branch/factory code
- pensionable pay
- membership category and status
- contribution rate
- normal retirement date

Some of these details will require updating from time to time.

If the scheme is being used for automatic enrolment, the automatic enrolment date will be required. Additionally, the pension scheme may require the employer to provide the following member data for the purposes of automatic enrolment:

- postal work address
- work email address (if one exists)
- personal email address (if the employer holds this information)
- gross earnings in any pay reference period
- the value of any contributions payable to the scheme by the employer and eligible jobholder in the pay reference period

Further details will be added if, for example, a member pays AVCs, has a transfer in, becomes subject to a pension sharing order following divorce etc.

Members sometimes join a new scheme following a company takeover or merger under which their existing pension benefits are transferred to the new scheme. As part of the takeover or merger agreement, the new scheme may have to provide a level of benefits in respect of the transferred benefits that differs from the standard benefit in the new scheme. Also, special individual benefit promises may have applied to some members in their old scheme which will be honoured in the new scheme. The records for such members must be updated to accurately reflect the position. If members have paid AVCs which are transferred to the new scheme the records for such members must also be updated to reflect the AVCs.

Where members are transferred to a new employer under the Transfer of Undertakings (Protection of Employment) Regulations 2006/246 (the TUPE regulations) and the new employer offers membership of their scheme, certain requirements may apply to the benefits provided in the new scheme for these members (see Part 1, Chapter 1.2). The records for such members must be updated to accurately reflect the position.

Whatever system of record keeping is used, the records of each scheme member must be available for frequent processing and updating, on a daily basis if necessary. The data should enable the administrator to calculate members' benefit entitlements, produce annual benefit statements, identify cases that must be reported to HMRC and provide the data required by the actuary for actuarial valuation purposes.

The Government asked the pensions industry to develop a pensions dashboard by 2019. The dashboard will be a digital interface where an individual will be able to view all their retirement savings in one place. The Pension Schemes Act 2021 requires the Money and Pensions Service to deliver a pensions dashboard with a target launch date of 2019, but this date has been pushed back. The most recent update (March 2024) will require schemes to provide data during 2025 ahead of the connection date of October 2025.

The Pensions Regulator's record keeping requirements include details of specific member data items that schemes must hold. Schemes must be able to test for both the existence and accuracy of their member data to demonstrate that they are meeting the regulator's standards and, if necessary, put in place an action plan to address any data deficiencies. The regulator's guidance on this area, and other resources to help trustees with record keeping, is available at: **Review your pension scheme data | The Pensions Regulator**

Annual Updating of Records for Active Members.

This is also referred to as the annual renewal.

Updating members' records with new salary information following salary reviews etc. provides administrators with the details needed to calculate benefits and to provide insurers with the data required for insured benefit renewals and re-broking exercises.

An annual update of records usually takes place at the end of the 'scheme year'. The employer must ensure that all relevant information concerning every member is given to the administrator. There is a legal requirement on employers to provide any information requested by schemes for the calculation of members' pension input amounts (see Part 3, Chapter 1.3.3).

Although details of pay changes may only be given once a year, entry to schemes will often take place at any time during the year (for example, if the employer is using their DB scheme to automatically enrol new employees). Furthermore, changes in death in service benefits and marital status changes are usually effective from the actual date of the event. A consolidated list of changes may therefore be provided at the annual renewal. If the scheme is not being used for automatic enrolment and entry to the scheme takes place annually, completed application forms for new members should be provided as part of the annual updating exercise.

In addition to revised earnings details, the information required could include details of all member contributions paid, changes in part time hours, details of any periods of temporary absence or maternity, paternity or adoption leave etc.

Before the exercise is completed, a number of reconciliations are usually carried out. For instance, that:

- the sum of the individual contributions equals the amount paid during the year
- the total number of active members agrees with the employer's records
- all members recorded as being 'active' have paid contributions during the year

Ad Hoc Events

Although the annual renewal exercise represents the core update of scheme records, administrators also need to update records on an ad hoc basis when certain events occur, such as new entrants and leavers, retirements or deaths of existing members, changes of members' marital status, address, or other data.

2.8.2 Communicating Information

Members should be given regular information about the benefits they are accruing. The disclosure regulations give members the right to request, once a year, a statement of their accrued benefits payable from normal pension age. In practice, however, the vast majority of DB schemes automatically provide this information to active members annually in the form of an annual benefit statement, despite there being no legal requirement to do so.

There is a legal requirement for a DB scheme to automatically provide an annual benefit statement covering any DC benefits, including AVCs and any DC underpin. This statement must include a Statutory Money Purchase Illustration (SMPI) unless the trustees determine that the benefits from the DC underpin are unlikely to be greater than the DB benefits for the member concerned.

The annual benefit statement may also state the increase in value of the member's defined benefits over the previous year. This information can help members determine whether or not they may be subject to an Annual Allowance charge on the increase in their benefits. See Part 3, Chapter 1.3.3 for more details.

The disclosure regulations allow schemes to comply by providing information electronically (i.e., by email, or posting on a website) instead of sending it by post. Certain conditions have to be met for instance, if a scheme wishes to use electronic communications, members must be notified in advance and must be able to choose to continue to receive information by post if that is what they prefer.

Summary

Most DB schemes require members to pay contributions towards the cost of their benefits. Contributions must be paid across to the scheme within set time limits.

In addition to their normal contributions, members may decide to pay additional voluntary contributions (AVCs) to secure additional benefits. AVCs may be paid on a DC or a DB basis and there is a variety of benefits which may be paid from those AVCs.

Whatever the type of AVCs, it is important that contributions are invested promptly in line with members' investment choices, and accurate records kept.

Members with benefits in another pension scheme may, if the trustees allow, transfer those benefits into their current scheme. Transfers in are now relatively rare, not least because of unresolved difficulties relating to equalisation of the transferring scheme's benefits and whether any GMPs need to be equalised.

Members may have periods of temporary absence due to ill health, family related or maternity leave etc., which may or may not be pensionable.

Member records must be accurate and kept up to date. Where appropriate, they must also reflect any special requirements such as the treatment of any transferred benefits as part of a company takeover

Self Test Questions

- Describe the factors that might influence a scheme's employee contribution rate.
- Outline the objectives of DC AVC scheme administration.
- Outline the factors that might influence a member's decision as to whether or not to transfer benefits into a scheme.
- List eight items of data that a scheme will need to administer a new member's benefits, including at least two that are specifically required under automatic enrolment.
- Describe the process that might be followed when a scheme undertakes its annual renewal.
- Outline the events that may trigger the updating of membership data.

CHAPTER 3

Retirements and Deaths

INTRODUCTION

The primary function of a pension scheme is to provide benefits for and in respect of members, so it is important to understand the range of benefits that may be available before looking at the broader issues of funding and winding up in later Parts of this study manual.

By the end of this chapter, you should know the types of benefit that may be payable on the retirement or death of a scheme member and how to comply with the necessary legislative requirements. As a matter of good practice, schemes should have standard processes and procedures in place to deal with these events, so that they can process cases efficiently and meet the legislative requirements.

Note that reference to spouse in this chapter includes spouses under a same sex marriage or civil partnership.

From 6 April 2006 there were some key changes to the legislative requirements, and it is important to understand some of those changes before looking at the actual payment of scheme benefits:

- the previous HMRC maximum contribution and benefit limits were replaced with the Annual Allowance (AA) and Lifetime Allowance (LTA)
- the Finance Act 2004 introduced Benefit Crystallisation Events (BCEs) of which there are now 13. Prior to 6 April 2024 when a BCE occurs a member's benefits must be tested against their available LTA. Where the value of a member's benefits exceeds their available LTA, the excess benefits can be paid either as a pension or as a lump sum (known as a lifetime allowance excess lump sum) but special tax charges will apply to the excess
- schemes could retain the previous HMRC maximum limits in their rules, but members' benefits must still be tested against their available LTA at any BCE prior to 6 April 2024
- members could protect their benefits against the Lifetime Allowance charge by registering for an enhancement to the LTA, enhanced protection or (more recently) fixed protection 2012, fixed protection 2014, fixed protection 2016, individual protection 2014 or individual protection 2016 as described in Part 3, Chapter 1.2
- HMRC introduced authorised and unauthorised payments as described in the Overview to this Part

Further key changes took place on 6 April 2015 when pension flexibility was introduced. The changes mainly affect DC arrangements, in particular allowing members to take one or more cash sums from uncrystallised DC funds without the need for a pension, known as an uncrystallised funds pension lump sum (UFPLS). However, as many individuals have both DB & DC benefits within the same scheme, the impact of the pension flexibilities will be felt by most pension schemes.

3.1 RETIREMENTS

Pension schemes will have a specified 'normal pension age' (NPA) which is the age at which members are expected to start receiving their pension. Members may, however, retire earlier or later than this age.

We will look at the position for retirements at NPA first and then consider the additional issues that might apply when retirement is from a different age.

Three main types of pensions must be distinguished for this chapter:

- a scheme pension, meaning a pension provided from an employer's DB or DC arrangements or by an insurance company selected by the trustees. Where DC benefits are involved, the trustees must have given the member the opportunity to have a lifetime annuity instead
- a lifetime annuity (an annuity contract purchased from an insurance company) from DC arrangements only
- drawdown pension, either as income drawdown or a short-term annuity, from DC arrangements only

Retirement cash sums are referred to in this chapter as pension commencement lump sums (PCLS). This reflects the fact that they will generally be paid in connection with a pension coming into payment. Where these conditions are met, the entire cash sum can be classed as a PCLS and paid tax-free. The maximum amount of PCLS payable is generally 25% of the value of the benefits being crystallised. Most schemes will offer cash sums to retiring members, subject to these requirements. If the member has any DC AVCs, the member is now able to take those AVCs as a UFPLS instead of using them to purchase additional pension. The maximum PCLS has been frozen at £268,275 so any cash above this will be taxed at the member's marginal rate of income tax. The LTA which used to restrict benefits was removed from 6 April 2024 but the lifetime allowance charge was removed from 6 April 2023.

3.1.1 Retirement at Normal Pension Age (NPA)

A member's benefits depend on his/her pensionable earnings at or shortly before retirement (if a final salary scheme) or across his/her entire period of scheme membership (if a Career Average Revalued Earnings scheme). Members usually have some choice over the exact nature of the benefits to be provided, for example they may have the option to commute part of the pension for a PCLS.

The employer should supply the administrator with details of the member's final earnings shortly before the retirement date, so that the administrator can provide details of the benefits and options. The member can then decide how to take their benefits.

In some cases, exact earnings details may not be known for certain before the retirement date, and if so the quotation provided to the member should make it clear that the benefits quoted could change. The benefits quoted should include any special benefits, for example individual benefit promises granted to certain members.

The quotation provided to the member should cover the following aspects:

- the options available to the member, usually either a full pension or a reduced pension and a PCLS
- details of how the pension will be paid (e.g., monthly in advance), how it will increase whilst in payment and any guarantee period that applies
- details of any spouse's/civil partner's pension payable on the member's death after retirement and how this pension will increase once in payment
- the treatment of any AVCs the member has paid (see AVCs, below)
- prior to 6 April 2024, an estimate of the percentage of the LTA that will be used up by both the main scheme benefits and any AVCs

The member should also be told what actions they need to take to enable the benefits to be paid, for example:

- confirming which benefits they require
- the completion of a bank mandate to enable the pension to be paid to the member's bank account
- prior to 6 April 2024, the completion of a declaration confirming whether they have previously crystallised (taken) any pension benefits from other registered pension schemes, or whether they will do so before or on the same day as they take their benefits from this scheme
- the provision of birth and marriage/civil partnership certificates of the member and spouse/civil partner (if not already produced)

AVCs

HMRC allows members to take their DC AVCs as a PCLS provided that the PCLS taken does not exceed the maximum permitted amount (generally 25% of the value of the benefits crystallising). However, not all schemes offer members this option. Whether any PCLS is available from AVCs will depend on the scheme rules.

Members now have the opportunity to transfer their uncrystallised DC AVCs at any time or they can make use of any options available from the scheme, including UFPLS, drawdown pension or lifetime annuity.

The requirement to give the member the choice of provider for their DC AVCs where they are using them to purchase a lifetime annuity has been removed although many schemes may still provide this choice.

Where DC AVCs are being taken as a scheme pension, the member must still be given the option of using them to purchase a lifetime annuity. If a scheme pension (including an insured scheme pension) is provided and the member was not given the option of purchasing a lifetime annuity, payment of the AVC scheme pension will be unauthorised.

Checks Required by HMRC

A Benefit Crystallisation Event (BCE) occurs when a member becomes entitled to their pension benefits. Prior to 6 April 2024, if the member was entitled to an enhancement to their LTA, or had enhanced, individual or fixed protection status, they had to provide the scheme administrator with evidence of this entitlement before the benefits were set up, as this was relevant to the maximum available pension commencement lump sum..

Disclosure Regulations

The disclosure regulations require details of the benefits payable (including any benefit payable on death), and conditions of payment, to be provided to the member automatically before or within one month of NPA. Where the benefit is payable periodically, the information must include the conditions for continuing payment and the provisions for changing the amount in future.

If the member has any DC AVCs there are additional disclosure requirements which must be complied with at least four months before the date of retirement, through the provision of retirement risk warnings at the point the member is able to access their benefits or make a decision and within one month of NPA.

3.1.2 Taking Pension After the Stated NPA (i.e., Late Retirement)

The principles described above for retirement at NPA apply equally to late retirement, however the member's benefits may be increased in respect of the late retirement in one of two ways:

- the member's benefits payable from NPA may be increased by a factor which takes into account the period of postponement, interest, shorter life expectation and, if applicable, an escalation percentage, or
- the period of service after NPA may count for extra accrual at the normal rate

If any benefits have not been taken by age 75, a BCE will occur. When the benefits are put into payment after age 75, this will not be a further BCE.

Disclosure Regulations

The disclosure regulations require information to be provided to the member automatically before or within one month of the late retirement date.

3.1.3 If the Scheme was Contracted Out

If a member of a formerly contracted out scheme has pre 6 April 1997 contracted out service they are entitled to a Guaranteed Minimum Pension (GMP) (unless the GMP has been converted to ordinary scheme benefits) payable from GMP payment age (65 male, 60 female).To obtain confirmation of the GMP payable at GMP payment age, schemes can use HMRC's online GMP checker shortly before the member reaches GMP payment age.

Where GMPs have been converted NIC&EO will still make a deduction from the member's State Second Pension (S2P) entitlement or, for individuals entitled to the new State pension, the GMP will be taken into account in determining the State pension due. Schemes converting GMPs may want to retain records of GMPs in case of a query from a member when their state benefits become payable.

The pension in respect of service before 6 April 1997 paid by the scheme from GMP payment age must not be less than the GMP.

Payment of a scheme pension, including the GMP element, may be postponed after GMP payment age if the member is still employed. If payment of the GMP is postponed for at least seven complete weeks, the GMP must be increased by the scheme by 1/7% for each complete week of postponement. The post '88 GMP must also be increased as if it was in payment (i.e., by the lower of the increase in the Consumer Prices Index and 3%).

GMPs may be commuted on triviality grounds or in cases of serious ill health, although scheme rules may prohibit commutation of GMPs.

No individual check is required against the member's contracted out benefits in respect of service between 6 April 1997 and 5 April 2016.This is because, for this period, under the reference scheme the test applied for the scheme as a whole and the scheme actuary will have already certified that, overall, the scheme provided a minimum level of benefit when compared with a statutory reference scheme.

3.1.4 Taking Pension Before NPA i.e. Early Retirement

On a Voluntary or Redundancy Basis

The principles described above for retirement at NPA also apply to early retirement, with the following modifications:

- early retirement is usually subject to the consent of the scheme trustees and possibly also the employer individuals who take their pension and/or PCLS from a registered pension scheme before age 55 (the normal minimum pension age) will be subject to unauthorised payment tax charges unless the member has a protected pension age (see below) or is retiring on grounds of ill health (also see below). From 6 April 2024 the minimum retirement age increases to 57.
- some members may have protected pension ages giving them a right to take their benefits before age 55. Protected pension ages apply to members who had an unqualified right on 5 April 2006 to take their benefits before age 50 (for example professional sports people or people in hazardous occupations), or between age 50 and 55. An unqualified right means that the member does not need anybody's consent to take their benefits
- benefits are generally calculated in the same way as for retirements at NPA using pensionable service up to date of leaving but are usually reduced (or 'discounted') for early retirement. Occasionally e.g., on redundancy, early retirement pensions may be augmented (enhanced) by the employer with the consent of the trustees and subject to any associated funding costs being calculated and paid as necessary

On Grounds of Ill Health

If an employee is suffering ill health before NPA, he/she may be eligible for an ill health early retirement pension from the scheme. The scheme rules will define the conditions that must be met for this benefit to be provided and it may be subject to the trustees' consent.

Ill health pensions are often augmented either as of right in accordance with the scheme rules, or at the discretion of the trustees and/or the employer.

Disclosure Regulations

The disclosure regulations require information to be provided automatically to the member before or within two months of the early retirement date.

Checks Required by HMRC

For early retirement on a voluntary or redundancy basis, the checks described for normal retirement apply. For retirements due to ill health the HMRC requirements are that the Scheme Administrator has received evidence from a qualified medical practitioner (usually in the form of a written report) to the effect that the member is, and will continue to be, medically incapable (either physically or mentally) as a result of:

- injury
- sickness
- disease,
- disability of continuing his or her current occupation and that the member has actually ceased to carry on their occupation.

The scheme rules may allow the pension to be reduced or suspended if the member makes a partial recovery or returns to full health. Where this is the case the member should be advised of this possibility at the point of retirement.

HMRC allows a member in 'serious ill health' to commute any uncrystallised rights they may have at any age provided the payment extinguishes all the member's uncrystallised rights in the arrangement. HMRC requires this term to be interpreted strictly and narrowly. The Scheme Administrator must have received evidence from a registered medical practitioner that the member's life expectancy is less than one year. In addition, as the payment must extinguish all of the member's entitlement to benefits under the arrangement, any survivors' benefits must be moved to a separate arrangement before the lump sum is paid

Serious ill health lump sums are tax-free if paid before age 75

If a serious ill health lump sum is paid on or after age 75 it will be subject to Pay-As-You-Earn (PAYE) tax based on the member's marginal rate of tax.

It is important that, in determining whether a member qualifies for ill health or serious ill health retirement, the provisions of the scheme rules are followed carefully and all HMRC requirements are met to avoid a decision being challenged.

Once it has been established that the relevant conditions for the particular type of ill health have been met, the procedures are as outlined above for the other retirement types.

3.1.5 If the Scheme was Contracted Out

GMPs are not payable before GMP payment age. Therefore, a check must be made to ensure that the expected pre-6 April 1997 pension that will be in payment at GMP payment age will be at least equal to the GMP at that age.

For pension accrued between 6 April 1997 and 5 April 2016 the contracting out requirements are the same as described above for normal or late retirement.

3.1.6 Payment of Lump Sums

HMRC requires that the PCLS must be paid within an 18-month period starting six months before and ending 12 months after the date of the relevant pension BCE. In practice, the PCLS will usually be paid on or shortly after retirement. In some circumstances, although the member may have confirmed that they want to take the cash option some time before retirement, it may not be possible to calculate the exact final amount until around the date of retirement. From 6 April 2024 the amount of the PCLS that is tax free is capped at the Lump Sum Allowance limit of £268,275 (unless certain protections are in place) with tax applied to any excess at the individual's marginal rate.

Trivial Commutation

There are several trivial commutation options potentially available to members with small benefits. Under the standard trivial commutation option which applies for DB benefits and DC in-scheme pensions (in payment) only, for the payment of a trivial commutation lump sum to be an authorised payment:

- the member must have reached age 55
- the value of the member's pension rights including any DC rights under all registered pension schemes, including any pensions currently in payment, must not exceed £30,000
- prior to 6 April 2024, it must be paid when all or part of the member's LTA is available
- it must be paid within 12 months of the date the member received their first trivial commutation payment from any other scheme
- it must extinguish the member's entitlement to DB benefits and to any DC in-scheme pensions (in payment) under the scheme
- from 6 April 2024 individuals must have all of their Lump Sum Allowance available to be able to take a trivial commutation lump sum.

From 1 December 2009, some other trivial commutation options were introduced under which small benefits can be commuted, provided that the scheme rules allow such payments to be made. The payment limit for these small commutations is £10,000.

For any type of trivial commutation payment, if it comes from benefits that are not already in payment, 25% of the trivial commutation lump sum is payable tax-free, with the balance being subject to PAYE tax. If the payment comes from benefits that are already in payment, the whole payment is subject to PAYE tax.

Uncrystallised Funds Pension Lump Sums

Members with DC AVCs are now able to take one or more UFPLS instead of taking a pension from their AVC funds. To be a UFPLS the lump sum must be paid:

- from uncrystallised DC rights
- when the member has reached normal minimum pension age (unless the ill health condition is met)

All UFPLS are paid 25% tax-free with the remaining 75% taxable at the member's marginal rate.

Not all pension schemes will allow members to take a UFPLS, in which case the member will need to transfer out their DC AVCs to a scheme that allows this option if the member wishes to take a UFPLS.

3.1.7 Pension Increases

Once in payment, pensions are increased according to whether or not the arrangement was contracted out, the legislative requirements, scheme rules and the sponsoring employer's practice. Since 1 January 2011, statutory increases to pensions in payment have been based on increases in the Consumer Prices Index (CPI) rather than the Retail Prices Index (RPI).

GMPs

- GMP for service between 6 April 1988 and 5 April 1997 must be increased by the scheme each year by the lower of 3% or the increase in the CPI
- Where an individual reached State Pension Age before 6 April 2016, increases on GMP for service between 6 April 1978 and 5 April 1988, and increases above 3% / CPI on GMP for service between 6 April 1988 and 5 April 1997, are provided by the State each year. Increases apply on 6 April each year based on the increase in the CPI for the 12 months ending the preceding September and are added to the State Second Pension (S2P)
- Where an individual reaches State Pension Age on or after 6 April 2016, the State does not provide increases on GMP for service between 6 April 1978 and 5 April 1988 or increases above 3% / CPI on GMP for service between 6 April 1988 and 5 April 1997

Excess Elements

- There is no legal requirement to increase any remaining pre-6 April 1997 pension in excess of the GMP. Nevertheless, many schemes pay regular increases either on a guaranteed, discretionary or guaranteed plus discretionary basis
- Any pension which relates to service between 6 April 1997 and 5 April 2005 (except AVC pensions), must increase every year at the lower of 5% or the increase in the CPI for the 12 months ending the preceding September. This basis is referred to as Limited Price Indexation (LPI). LPI need not be applied to pensioners under 55 unless retirement was due to ill health, although at age 55 the pension must be increased to what it would have been had LPI applied
- For pension in respect of service from 6 April 2005 it is possible (but not compulsory) for the trustees to adopt LPI at a lower rate of 2.5% or CPI if lower

Note that the above are statutory minimum pension increase requirements. Some schemes may continue to use RPI as the increase basis and/or apply a different reference period and these schemes are exempt from the statutory requirements.

Disclosure Regulations

If the method of increasing pensions changes, members must be notified automatically before or within one month after the change.

3.1.8 Flexible or Phased Retirement

HMRC does not require members to leave employment to take their pension. Members can also draw their pension in stages. Therefore, subject to the rules/policy agreed by the trustees and employer, a member may be able to retire at any time from age 55 and draw all or part of their pension while continuing to work full or part time and possibly accruing further pension. If a member draws their pension in stages, then each 'retirement' represents a new BCE. However the Finance Act 2022 increases normal minimum pension age to 57 from 6 April 2028.

With the introduction of pension flexibility, phased retirement may become more common; for example, members may, if their scheme allows it, use their DC AVCs to provide occasional UFPLS payments to supplement their income, before payment of their DB pension starts.

Alternatively, members may transfer their benefits to a different scheme to make use of the pension flexibilities.

If a member is drawing their pension earlier than age 55 (57 from 2028) because they have a protected pension age, all of their benefits must come into payment at that time otherwise the pension (paid up to age 55) and any PCLS would be unauthorised.

The record keeping requirements for phased retirements are more complicated than for 'full retirement' cases, as the scheme must maintain both a pensioner record and an active member record for the individual. Consequently, not all schemes allow members to take flexible or phased retirement.

3.1.9 Transfers at Retirement

Increasingly, many private sector occupational pension schemes are providing their members with a cash equivalent transfer value as part of their retirement options. Members then have the choice of taking their retirement benefits within the scheme or transferring to a new scheme to access the pension flexibilities (including UFPLS and drawdown pension) thereby increasing the options open to them on retirement.

3.2 DEATH BENEFITS

Three main types of lump sum death benefit need to be distinguished for this chapter:

- a defined benefits lump sum death benefit, which is a lump sum paid from a defined benefits arrangement on the death of a member. This includes lump sum death benefits based on multiples of earnings, service, or another factor. The majority of the lump sum death benefits described will be defined benefits lump sum death benefits
- a pension protection lump sum death benefit, which is a lump sum death benefit paid from a defined benefits arrangement in respect of a scheme pension that the member was entitled to receive. This includes lump sum guarantees following the death of a member. Members must specify if they want a lump sum death benefit to be treated as a pension protection lump sum death benefit
- an uncrystallised funds lump sum death benefit, which is a lump sum death benefit paid from a DC arrangement on the death of an active or deferred member

In addition to the above, if the value of a dependant's pension is no more than £30,000, it is possible for it to be commuted entirely as a lump sum (known as a trivial commutation lump sum death benefit), provided the scheme rules allow this.

Before any death benefits are paid, the administrator (and insurer where applicable) will need sight of the original death certificate. If there is a spouse/civil partner and/or children to whom pensions are payable, their birth certificates (and marriage/civil partner registration certificate) and bank details will also be required.

In some schemes, discretion exists to pay a spouse's pension to a financially dependent partner. In these cases, evidence needs to be gathered and the case referred to the trustees for a decision.

On the death of a member, an annuity or drawdown pension can also be provided to a nominee and a successor from a DC arrangement. This means that where a pension can be paid from DC AVCs, members have greater scope in passing on their pension to others.

3.2.1 The Benefits

Death in Service Before NPA

Typically, the benefits payable would be:

- a lump sum death benefit calculated as a multiple of the member's salary
- dependants' pensions payable to a spouse/ civil partner and also to children who meet any conditions specified in the scheme rules and by HMRC ('qualifying children'). (See Part 2, Chapter 3.2.6 for details of the conditions that may be imposed)

The lump sum will usually be payable under a discretionary trust (see Part 2, Chapter 3.2.3).

A refund of the member's contributions may also be payable under a discretionary trust or may be payable automatically to the legal personal representatives. Where legal personal representatives are involved, the Grant of Probate or Grant of Letters of Administration should be obtained before payment is made.

Death in Service After NPA

In these circumstances the member would normally be treated the same as for death in service before NPA but this will depend on the scheme's rules. Usually therefore the benefits payable would be as described above.

Death in Early Retirement Before NPA Typically, the benefits payable would be:

- dependants' pensions payable to a spouse/civil partner and also possibly to qualifying children
- a lump sum representing the balance of the pension that would have been paid to the member during a 'guarantee period' (usually five years from the retirement date)

A further lump sum death benefit may also be payable similar to the lump sum payable on death in service before NPA.

Death in Retirement After NPA

Typically, the benefits payable would be:

- dependants' pensions payable to a spouse/civil partner and also possibly to qualifying children
- a lump sum representing the balance of the pension that would have been paid to the member during a 'guarantee period' (usually five years from the retirement date)

Members Who Die Following Flexible Retirement

In these circumstances the benefits payable will depend on what the scheme rules provide for but may include both a death in service lump sum and a death after retirement lump sum. In addition, spouse's/civil partner's and children's pensions may also be payable.

Deferred Pensioners

Typically, the benefits payable would be:

- dependants' pensions payable to a spouse/civil partner and possibly to qualifying children and/or
- a refund of the member's own contributions

Disclosure Regulations

For all death cases the disclosure regulations require that details of the benefits and options available must be quoted within two months of the trustees receiving notice of the death.

3.2.2 Payment of Lump Sum Death Benefits

As for other benefits, the payment of lump sum death benefits is governed by the scheme rules. In addition, however, under many schemes the trustees will have discretion as to who should receive the lump sum death benefit.

3.2.3 Exercise of Trustees' Discretion

Lump sum death benefits are often paid to a recipient selected at the discretion of the trustees. The usual practice is as follows:

- the member will have been asked to nominate one or more beneficiaries by completing a nomination or expression of wish form, although the trustees are not obliged to comply with this nomination
- the trustees will determine the potential recipient(s) taking account of both the member's nomination form and also the member's personal circumstances at death
- the trustees usually make their decision as to which of the potential recipient(s) will receive a lump sum death benefit, and in what shares, at a full trustee meeting or through an appointed committee

The benefit of paying lump sum death benefits under the trustees' discretionary powers is that they do not form part of the deceased's estate and therefore are not assessable for inheritance tax.

3.2.4 If the Scheme was Contracted Out

Where a member dies with an entitlement to contracted out benefits, subject to certain qualification requirements:

- widows are entitled to 50% of the whole GMP in respect of all contracted out service prior to 6 April 1997, and a pension of 50% of the member's pension (before commutation) for service between 6 April 1997 and 5 April 2016 to meet reference scheme test conditions
- widowers (including widowers from same sex marriages)/civil partners/widows of female members under same sex marriages are entitled to 50% of the post 5 April 1988 GMP only, and a pension of 50% of the member's pension (before commutation) for service between 6 April 1997 and 5 April 2016 to meet reference scheme test conditions

Where GMPs have been converted to ordinary scheme benefits, survivors' benefits must be provided from the converted benefits in the same circumstances and for the same service periods that would have applied had the GMP not been converted.

3.2.5 Checks Required by HMRC

If a defined benefits or uncrystallised funds lump sum death benefit is paid on the death of a member before age 75 within two years of the earlier of:

- the day on which the Scheme Administrator first knew of the member's death, and
- the day on which the Scheme Administrator could have first reasonably known about the member's death

its payment will be a BCE. These lump sum death benefits are known as relevant lump sum death benefits and are tax-free.

From 6 April 2024, death benefits are tested against the Lump Sum and Death Benefits Allowance limit of £1,073,100 (this may be higher if certain protections are in place). Any tax charge payable on the excess is payable by the recipient of the lump sum, so the Scheme Administrator always pays any relevant lump sum death benefit gross.

The Scheme Administrator must inform the member's legal personal representatives of the amount and date of the payment of any lump sum. This must be done within three months of the final lump sum being paid..

If a defined benefits or uncrystallised funds lump sum death benefit is paid on the death of a member

- before age 75 but after the two-year period (mentioned above) has ended, or
- on or after age 75

its payment will not be a BCE and it will be taxable at the marginal rate of the recipient. This tax charge will be deducted by the scheme.

As an alternative, schemes may allow members to opt for any lump sum death benefit payable from a DB arrangement on their death after retirement to be treated as a pension protection lump sum death benefit. This is because this type of benefit is paid tax-free where the member dies before age 75 and is not a BCE. Where the member dies on or after age 75, tax is payable at the marginal rate of the recipient.

For members who die after retirement, generally, any pension payments paid in respect of any period after death must be recovered otherwise the overpaid pension will become an unauthorised payment, unless the payments represent a continuing guarantee on the member's pension. This can be done by recalling the payment from BACS or requesting repayment from the estate. There are two exceptions to this requirement which apply where the Scheme Administrator was not aware of the member's death:

- the total overpaid does not exceed £250 net of tax, or
- the overpaid instalment(s) were paid within six months of the member's death

If the member retired after 5 April 2006 and died after age 75, any dependant's pension payable must not exceed the amount of member's pension paid in the previous twelve months, plus 5% of any PCLS paid on retirement. Any amount in excess of this limit would be unauthorised. Since 6 April 2016 this limit only applies where the total dependant's pension payable from the scheme is greater than the higher of:

- £25,000, or
- the total annual rate of pension that the member was actually and/or prospectively entitled to receive from the scheme

3.2.6 Payment of Pensions to Dependants, Nominees and Successors Payment of Beneficiaries' Pensions

There are a few points to be aware of:

- Spouses'/civil partners'/dependants' scheme pensions are taxable under the PAYE system. Children's scheme pensions should always be set up in the name of the child, even if they are being paid into the spouse's bank account, to ensure that the spouse is not taxed on the child's income. Where an annuity or drawdown pension is payable to a beneficiary from DC funds following the death of a member under age 75, these pensions are payable tax-free as long as the first payment of pension was made on or after 6 April 2015. Where the member died over age 75, the pension is subject to tax under PAYE
- Scheme rules may specify a maximum age at which the payment of children's pensions ceases. It could be a fixed age e.g., 16 or 18 or depend on whether the child is still in full time education. HMRC requires children's pensions to cease at 23, except in special circumstances
- Scheme rules may include a definition of 'dependant' where the partners are not in a marriage, same sex marriage or registered civil partnership. Even if the rules do not, HMRC imposes conditions on who can be treated as a dependant of a member and so be entitled to a dependant's pension
- Registered civil partners and widows of female members under a same sex marriage must, as a minimum, receive the same benefits as widowers in respect of contracted out benefits and the member's service from 5 December 2005. For benefits accrued before this date (except contracted out benefits) the scheme rules will dictate whether registered civil partners and same sex spouses are entitled to the same benefits as a spouse
- As part of the pension flexibility changes, members are now able to nominate, as an alternative to a dependant, a person (a nominee) to receive a pension from their DC funds, including AVCs, following their death. Beneficiaries including dependants are also able to nominate a successor who would then receive a pension from any remaining DC funds following the death of the beneficiary

Evidence of Continued Existence

To avoid making unauthorised payments and to prevent possible fraud, pension schemes should require members or dependants receiving a pension to prove continued existence and certificates to this effect should be requested at regular intervals, preferably certified by a professional person such as a doctor or solicitor.

For members who die after retirement, generally, any pension payments paid in respect of any period after death must be recovered otherwise the overpaid pension will become an unauthorised payment, unless the payments represent a continuing guarantee on the member's pension. This can be done by recalling the payment from BACS or requesting repayment from the estate. There are two exceptions to this requirement which apply where the Scheme Administrator was not aware of the member's death:

- the total overpaid does not exceed £250 net of tax, or
- the overpaid instalment(s) were paid within six months of the member's death

If the member retired after 5 April 2006 and died after age 75, any dependant's pension payable must not exceed the amount of member's pension paid in the previous twelve months, plus 5% of any PCLS paid on retirement. Any amount in excess of this limit would be unauthorised. Since 6 April 2016 this limit only applies where the total dependant's pension payable from the scheme is greater than the higher of:

- £25,000, or
- the total annual rate of pension that the member was actually and/or prospectively entitled to receive from the scheme

Dependants' and spouses'/civil partners' pensions do not count towards the member's or recipient's LTA.

3.2.7 Payment of Pensions to Dependants, Nominees and Successors

Payment of Beneficiaries' Pensions There are a few points to be aware of:

- Spouses'/civil partners'/dependants' scheme pensions are taxable under the PAYE system. Children's scheme pensions should always be set up in the name of the child, even if they are being paid into the spouse's bank account, to ensure that the spouse is not taxed on the child's income. Where an annuity or drawdown pension is payable to a beneficiary from DC funds following the death of a member under age 75, these pensions are payable tax-free as long as the first payment of pension was made on or after 6 April 2015. Where the member died over age 75, the pension is subject to tax under PAYE
- Scheme rules may specify a maximum age at which the payment of children's pensions ceases. It could be a fixed age e.g., 16 or 18 or depend on whether the child is still in full time education. HMRC requires children's pensions to cease at 23, except in special circumstances
- Scheme rules may include a definition of 'dependant' where the partners are not in a marriage, same sex marriage or registered civil partnership. Even if the rules do not, HMRC imposes conditions on who can be treated as a dependant of a member and so be entitled to a dependant's pension
- Registered civil partners and widows of female members under a same sex marriage must, as a minimum, receive the same benefits as widowers in respect of contracted out benefits and the member's service from 5 December 2005. For benefits accrued before this date (except contracted out benefits) the scheme rules will dictate whether registered civil partners and same sex spouses are entitled to the same benefits as a spouse
- As part of the pension flexibility changes, members are now able to nominate, as an alternative to a dependant, a person (a nominee) to receive a pension from their DC funds, including AVCs, following their death. Beneficiaries including dependants are also able to nominate a successor who would then receive a pension from any remaining DC funds following the death of the beneficiary

Evidence of Continued Existence

To avoid making unauthorised payments and to prevent possible fraud, pension schemes should require members or dependants receiving a pension to prove continued existence and certificates to this effect should be requested at regular intervals, preferably certified by a professional person such as a doctor or solicitor.

Summary

Members can retire at NPA or possibly earlier or later than NPA subject to meeting the relevant requirements. Where benefits are paid from an age that is not NPA, they are usually adjusted to reflect the early or late payment. Before a member retires, the scheme should provide him/her with details of the benefits available and the member will have to provide the scheme with certain information so that the benefits can be paid.

Payment of a pension, UFPLS or PCLS before age 75 is a BCE. If the benefits are not taken by age 75, a BCE automatically occurs at the member's 75th birthday.

Once in payment, a pension will usually increase each year and there are various statutory minimum increase rates that apply to different elements of the pension.

Following the death of a member there are a range of lump sum death benefits and dependants' pensions that may be paid, depending on the member's status. If the member had any contracted-out benefits, there are minimum levels of widows'/widowers'/surviving civil partners' pensions that must be paid.

The payment of a relevant lump sum death benefit before age 75 is a BCE. Lump sum death benefits are often paid to a person chosen by the trustees.

From 6 April 2024, there is a limit on the total amount of lump sums and lump sum death benefits that you can receive free from Income Tax. These are the Lump Sum Allowance and the Lump Sum and Death Benefit Allowance.

Self Test Questions

- Distinguish between a scheme pension and a lifetime annuity.
- What issues should trustees take into account when considering a request for ill health early retirement?
- Describe the minimum increases that must be provided on a pension in payment.
- Outline how benefits might be increased on late retirement.
- Describe the tax treatment of pensions payable following the death of a member.
- Explain the tax treatment of a pension protection lump sum death benefit and why a member might request that any lump sum benefit payable on their death after retirement is treated as a pension protection lump sum death benefit.

CHAPTER 4

Early Leavers and Transfers Out

INTRODUCTION

In this Part we have already looked at the requirements for new entrants and active members, as well as the benefits available when a member retires or dies. In this chapter we move on to consider the rights and options of members who leave pensionable service before retirement, the treatment of deferred pensions and members' rights to transfer their benefits to other pension arrangements.

Providing these members with the correct benefits and ensuring that all legislative requirements are complied with is again a fundamental requirement for a pension scheme. By the end of this chapter, you should understand the options available to early leavers and how to comply with the relevant legislative requirements.

4.1 EARLY LEAVERS

When an active member leaves pensionable service, the employer must notify the trustees (or, in practice, the administrator) and provide the information needed to calculate the member's benefit entitlement, for example details of their final earnings.

The factors that determine what benefits become payable and in what circumstances are:

- whether the member has opted out of the scheme as a result of being automatically enrolled, or enrolled following their request to opt in
- how much 'qualifying service' (see below) the member has completed
- whether the scheme is contributory or non-contributory for members
- whether the scheme was contracted out prior to 6 April 2016
- the rules of the scheme, for instance whether early retirement is available

Qualifying Service

Qualifying service broadly means the period of service that is taken into account to calculate the benefits a member is entitled to when they leave the scheme. It includes any period of service before entering the scheme which is classed as pensionable and any service in respect of a transfer value brought in from a previous arrangement (the latter is referred to as 'linked qualifying service').

4.1.1 Options on Leaving

If the Member Is Opting Out During the One-Month Automatic Enrolment Opt-Out Period

If an eligible jobholder is automatically enrolled into scheme membership, or a jobholder is enrolled following their request to opt in, they have the right to opt out of the scheme within one month of being enrolled.

If the member exercises this right, they are treated as never having been a member of the scheme and the employer must refund to them any contributions they have paid to the scheme. The employer must generally refund the contributions within one month of receiving the opt out notice from the employee.

If any of the member's contributions have been passed across to the pension scheme, the scheme must refund those contributions to the employer along with any related employer contributions (again generally within one month of the employer receiving the opt out notice from the employee).

If the Member Has Less Than Three Months' Qualifying Service (and is not Opting Out Within the One- Month Opt-Out Period)

The member is usually only entitled to a refund of their own contributions including any Additional Voluntary Contributions (AVCs) they have paid.

Tax is deducted at the rate of 20% on the first £20,000 of contributions (including AVCs) repaid and 50% on any contributions (including AVCs) repaid over this amount. Regardless of your tax status, you cannot reclaim the tax.

Any investment return on AVCs or interest awarded on ordinary contributions must be paid gross, and the member must then declare that amount to their local Inspector of Taxes. Tax will be levied directly on the individual.

If a member has transferred in benefits from a personal pension, they have a right to deferred benefits on leaving, whatever their period of qualifying service, and cannot have a refund of their contributions.

If the Member Has Between Three Months' and Two Years' Qualifying Service Usually a choice between:

- a refund of the member's own contributions (including any AVCs) which will be paid as described above.
- transferring the value of their benefits, known as a cash transfer sum, to another suitable pension arrangement, such as a new employer's scheme or a stakeholder or personal pension scheme

Within three months of the member leaving pensionable service, the trustees must notify them of their right to a refund or a cash transfer sum. Trustees may leave this option open indefinitely or may give the member a reasonable period (usually three months) to request a cash transfer sum. If this is not taken up the option will then lapse, and the refund of contributions will be paid instead.

Some schemes may be more generous and offer the member a deferred pension after less than two years' qualifying service. Where a deferred pension is offered, the member is not entitled to a cash transfer sum. Instead, they would be entitled to a cash equivalent transfer value - see Part 2, Chapter 4.2.

Again, if the member has brought a transfer into the scheme from a personal pension a refund or a cash transfer sum is not available.

If the Scheme was Contracted Out Where:

- an employee leaves pensionable service under a formerly contracted out scheme and takes a refund, and
- the leaving date is before the tax year in which they reach State pension age a contributions equivalent premium (CEP) in respect of pre-6 April 2016 contracted out service can be paid to the National Insurance Contributions and Employer Office (NIC&EO). This payment:
- restores the employee's rights in the State Second Pension as if they had not been contracted out, and
- extinguishes their right to any contracted-out benefits in the scheme

The CEP represents the employer's and employee's additional National Insurance contributions which would have been paid had the employee not been contracted out prior to 6 April 2016. The employer may recover from the employee's contribution refund an amount equal to the employee's share of the CEP, which is known as the 'certified amount'.

If the Member Has At Least Two Years' Qualifying Service

Under the Pension Schemes Act 1993, such members are entitled to preserved benefits in the form of a deferred pension within the scheme when they leave.

Where 'preservation' applies, the member has a right to a preserved benefit payable on retirement or death at or after normal pension age (NPA), in respect of all benefits (excluding lump sum death benefits) earned up to the date of leaving. Schemes may also provide deferred death before retirement pensions, although this is not required under preservation requirements.

Preservation and Disclosure Regulations

Under The Occupational Pension Schemes (Preservation of Benefit) Regulations 1991/167, members who leave pensionable service with preserved benefits must be provided, automatically, with details of their rights and options under the scheme (other than the amount of the transfer value) within two months of the trustees receiving notification of the termination of pensionable service.

The disclosure regulations allow members with deferred benefits to request details of the benefits that would be paid at NPA or on death. If requested, this information must be provided within two months. Having received this information, members are not automatically entitled to request it again free of charge during the next 12 months.

Members with deferred benefits can transfer their benefits to another occupational pension scheme or to a suitable insurance policy, personal or stakeholder pension scheme. See Part 2, Chapter 4.2 for information on transfers out.

If the Scheme was Contracted Out

If the accrued rights include a Guaranteed Minimum Pension (GMP), this must be revalued up to GMP payment age.

The method of GMP revaluation is set out in the scheme rules. Often the rules allow for either method (described below) and the trustees will have selected one when the scheme started to contract out. It must be the same for all leavers until the trustees elect to change it, from which time the new method will apply to all new leavers from the date of the election.

Members who leave during the tax year in which their GMP payment age falls do not receive any GMP revaluation.

Contracted out benefits accrued from 6 April 1997 to 5 April 2016 revalue in deferment in the same way as other non GMP benefits. See below.

Revaluation of Deferred Pensions

Under a DB arrangement, the trustees must increase the deferred pension between the date of leaving and retirement as follows:

Revaluation of the GMP Element

The GMP of early leavers must be revalued up to GMP payment age or earlier death. For members who terminated contracted out employment on or before 5 April 1997, schemes could revalue GMPs using either:

- Section 148 orders (previously called Section 21 orders) which is known as full rate revaluation
- a fixed rate
- a limited rate (full rate revaluation capped at 5% a year)

For members who terminated contracted out employment on or after 6 April 1997, schemes may only revalue using either Section 148 orders or a fixed rate. For active members ceasing to contract out as a result of the abolition of contracting out on 6 April 2016, the GMP continues to be revalued using Section 148 orders until pensionable service ceases. When pensionable service ceases the GMP is then revalued using either Section 148 orders or the fixed rate. Schemes which used limited rate revaluation before 6 April 1997 had to change to either full or fixed rate revaluation for leavers from then onwards. Limited rate revaluation can continue to apply for those members who left the scheme before 6 April 1997.

How these revaluation methods work is explained in Appendix C.

Anti-franking

The GMPs of early leavers are protected by anti-franking legislation. This legislation sets out a number of different elements of a member's pension which, in aggregate, make up a minimum amount of pension that has to be paid when the GMP comes into payment. The basic principle, however, is that any pension in excess of the GMP is not eroded by using it to offset the revaluation of the GMP.

Statutory revaluation on benefits in excess of the GMP (see below) must be paid in addition.

Excess Above GMP

This includes pension accrued from 6 April 1997 to 5 April 2016 on the reference scheme test basis. If a member leaves pensionable service at least one full year before NPA, the Pension Schemes Act 1993 requires that the deferred benefit, in excess of the GMP, is revalued up to NPA. The revaluation method depends on the nature of the scheme.

For members who leave pensionable service on or after 1 January 1991, all of the deferred benefit, in excess of the GMP, including benefits payable on death after NPA, must be revalued. For benefits provided on death before NPA, only the benefits accrued from 6 April 1997 to 5 April 2016 in a formerly contracted out scheme require revaluation.

Since 1 January 2011, future statutory revaluation increases before retirement are based on the Consumer Prices Index (CPI) rather than the Retail Prices Index (RPI).

For final salary schemes, deferred benefits must be revalued as follows:

- the deferred benefit accrued prior to 6 April 2009 must be increased for each complete year between leaving pensionable service and NPA by the lower of the increase in the CPI and 5% a year compound
- the deferred benefit accrued after 5 April 2009 must be increased for each complete year between leaving pensionable service and NPA by the lower of the increase in the CPI and 2.5% a year compound Note that the above are minimum revaluation requirements and some schemes may provide higher revaluation levels. For instance, some schemes:
- will still apply the 5% cap to benefits accrued after 5 April 2009 or adopt the lower rate at a later date, and/or
- continue to use RPI instead of CPI as the measure for price inflation for some or all of the member's benefits

Deferred benefits resulting from any DB AVCs (e.g., those providing added years) must be revalued as for excess above GMP benefits in final salary schemes.

Deferred benefits resulting from DC AVCs are revalued by virtue of any growth in the fund in the period up to retirement.

For career average revalued earnings schemes, the revaluation requirement under the Pension Schemes Act 1993 is met by either:

- revaluing deferred benefits in the same way as final salary schemes
- revaluing the salaries for deferred members in the same way that would have applied if the member had continued to be in active service

4.1.2 Leaving Pensionable Service (Outside of the Opt-Out Period Where the Scheme Is Being Used as an Automatic Enrolment Scheme) Without Leaving Employment

The Social Security Act 1986 gave employees the right to cease active membership of their employer's scheme at any time from 6 April 1988 without leaving employment. The scheme may impose certain conditions, such as the period of notice which the employee must give before leaving pensionable service (which may be up to three months) and the terms for re-joining in the future.

Prior to 6 April 2015, leavers in this category had a statutory right to transfer out any part of their entitlement which was earned after 5 April 1988 (entitlement earned before 6 April 1988 could be transferred once they left the company's employment although most schemes allowed a full transfer without the member leaving employment). From 6 April 2015 the statutory right to transfer out was extended to all benefit entitlement for leavers in this category.

4.1.3 Payment of Deferred Pensions at Normal Pension Age

Typically, the scheme will send a letter detailing the member's rights and options (including for any DC AVCs) to the member's last known address six months before NPA. Under the disclosure requirements, for members with DC AVCs, the scheme must also inform the member of their right to transfer their flexible benefits, provide information about the options in respect of the member's flexible benefits and inform them about the Government's Pension Wise service, four months before NPA. In practice, most schemes with members who have DC AVCs continue to write to members six months before NPA and include details of the pension flexibility options and Pension Wise service at that point. If the member does not respond, other attempts can be made to get in touch e.g., through the employing company's records, former colleagues, the Department for Work and Pensions' Bulk Letter Forwarding Service, specialist tracing agency etc.

If all this proves unsuccessful then the pension can be held in suspense until the member makes contact or a periodic review of suspended cases proves successful. Once contact has been made procedures will be similar to those for an active member, but the following points should be kept in mind:

- the terms attaching to the pension might be governed by the scheme rules in force when the member left pensionable service, e.g., the eligibility for an automatic dependant's pension
- some proof of identity should be obtained to ensure contact has been made with the correct individual

If a deferred benefit is not claimed within six years of entitlement arising, the scheme's rules may provide that the back payments due for periods more than six years ago may be forfeited, but not the right to the last six years' instalments or any future instalments. The rules may also give the trustees discretion to allow back payments due for periods more than six years ago to be paid in any event. If a member fails to claim their GMP beyond GMP payment age, instalments of GMP cannot be forfeited unless they relate to a period more than 8 years before the date of claim.

The same disclosure requirements apply when retiring from deferred status as apply when retiring from active membership.

The problem for occupational pension schemes in tracing members with deferred pensions was discussed above. A similar problem applies to members with deferred pensions who cannot trace the body responsible for paying their deferred pension. This can be for a number of reasons, such as company takeovers, mergers, liquidations, changes of names etc. Members can use the Pensions Tracing Service to trace former pension schemes:

Find pension contact details - GOV.UK (www.gov.uk)

4.1.4 Payment of Deferred Pension at Other Times

Members will generally have the option under the scheme rules to take their pension early or to postpone it beyond NPA if they are still working. This is usually subject to the consent of the trustees. The pension will normally be reduced or increased for early or late payment respectively.

4.2 TRANSFERS OUT

This chapter only deals with transfers between UK pension schemes.

Members who leave a pension scheme before retirement usually have the right to transfer the value of all of their benefits to another pension arrangement. From 6 April 2015, the Government made changes to the transfer requirements so that members have the statutory right to transfer out just one category of their benefits to another pension arrangement. Three categories of benefits are recognised for this purpose:

- money purchase benefits (also known as flexible benefits)
- flexible benefits that are not money purchase benefits (e.g., cash balance benefits)
- benefits not covered by the above two definitions (for example salary related or CARE benefits – so typically defined benefits – also known as safeguarded benefits)

The amount transferred is called the 'cash equivalent transfer value' of the member's benefits.

4.2.1 The Right to a Cash Equivalent Transfer Value

For defined benefits, members have a statutory right to transfer the cash equivalent of those deferred benefits to another suitable pension arrangement if:

- they have stopped accruing the defined benefits at least one year before NPA
- they have not used any of the defined benefits to provide a scheme pension
- the member's application to transfer is received at least one year before NPA

Members of unfunded public service DB schemes do not, however, have a statutory right to transfer defined benefits to an arrangement which could provide flexible benefits.

For DC AVCs (or money purchase benefits), members have a statutory right to transfer these benefits to another suitable pension arrangement (provided they are no longer accruing money purchase benefits within the scheme) at any time up until the point that the member:

- uses any of their money purchase benefits to provide a scheme pension or lifetime annuity, or
- designates any of their money purchase benefits as available for the payment of a drawdown pension

Trustees may allow a member to transfer their benefits even where the member does not have a statutory right to do so.

4.2.2 Statutory Discharge

Where a member exercises their statutory right to a transfer, the trustees of the transferring scheme have a full statutory discharge, so that they are not required to provide the member with any benefits in the category to which the cash equivalent related, so long as the receiving arrangement satisfies prescribed requirements. The exact requirements vary depending on whether the receiving arrangement is an occupational pension scheme, a personal pension, or a buyout policy.

A member with a statutory right to a transfer can split the cash equivalent of any category of benefit between as many occupational pension schemes, buy out policies and personal pension arrangements as they wish although, generally, for the statutory discharge to apply, all of the cash equivalent must be transferred.

If the member's defined benefits include any contracted-out element the member has a statutory right to transfer as follows:

- if the receiving scheme is unwilling to receive the contracted-out element, just the excess over the contracted-out element and leave the contracted-out benefits in the original scheme, or
- if the receiving scheme is willing to receive the contracted-out element, the whole defined benefit

If trustees allow a member to transfer their benefits where a statutory right does not exist, the trustees do not have a statutory discharge of their liability to provide benefits for the member. In these cases, trustees will usually insist that the member completes a form to acknowledge that the trustees will no longer be obliged to provide benefits for them.

4.2.3 Appropriate Independent Advice Requirement

Members must obtain appropriate independent advice before transferring safeguarded benefits to an arrangement to provide flexible benefits. The advice requirement applies where the value of the member's safeguarded benefits exceeds £30,000 regardless of the amount actually being transferred.

Where the full transfer value of the member's safeguarded benefits exceeds £30,000 the transferring scheme must tell the member that they will need to take appropriate independent advice before transferring their benefits to an arrangement providing flexible benefits. Prior to the transfer proceeding, the transferring scheme must receive written evidence from the member's adviser confirming that they have given the member advice relating to the transfer and that they are authorised to give such advice. The transferring scheme must also check that the adviser has permission to provide such advice by checking the Financial Services Register maintained by the Financial Conduct Authority.

4.2.4 HMRC Requirements

When a member transfers benefits they will lose their right to enhanced protection, fixed protection 2012, fixed protection 2014 or fixed protection 2016 unless the transfer is a permitted transfer. A transfer will be a permitted transfer if it is a transfer to a DC arrangement or, in limited circumstances, a transfer to a DB arrangement.

Similarly, when a member transfer benefits, they will lose their right to a protected pension age of below 55 or rights to a 'grandfathered' Pension Commencement Lump Sum (PCLS - i.e. a PCLS of more than 25% of the value of the member's pre 6 April 2006 benefits) unless the transfer is part of a block transfer, which is the transfer of benefits for more than one member as a single transaction.

A transfer from a registered pension scheme to another registered pension scheme is a recognised transfer under the Finance Act 2004. No tax charges or sanctions apply to recognised transfers. A recognised transfer from one registered pension scheme to another is not a BCE.

If the transferring Scheme Administrator has reason to believe that the member has previously flexibly accessed their pension rights (see Part 3, Chapter 1.3.5) they must inform the receiving scheme of this fact within 31 days of the completion of the transfer, together with the date on which they understand the member to have first flexibly accessed their pension rights.

A transfer from a registered pension scheme to a non-registered scheme is not a recognised transfer.

It is an unauthorised payment and will lead to tax charges against the member and the trustees of the transferring scheme. Members do not have a statutory right to a transfer that is not a recognised transfer, so any such transfers would only be paid at the discretion of the trustees and in accordance with the provisions of the scheme rules.

4.2.5 Calculation and Payment of Transfer Values

The trustees of registered pension schemes are responsible for determining the basis for calculating transfer values, and the assumptions used in DB transfer calculations, after taking advice from their actuary. This responsibility applies not only to cash equivalent transfer values, but also to cash transfer sums for short service leavers, valuations of benefits for divorce purposes and other transfer values for members who do not have a statutory right to transfer their benefits.

Trustees are also responsible for determining how to calculate benefits on a transfer into the scheme.

The transfer values legislation (The Occupational Pension Schemes (Transfer Values) Regulations 1996/1847) requires trustees to calculate an 'initial cash equivalent'. This is the minimum cash equivalent, calculated using a prescribed approach, before any reductions are applied.

The final 'cash equivalent' may be either:

- the initial cash equivalent minus any reductions, or
- an alternative cash equivalent, provided this is higher than the initial cash equivalent above

The initial cash equivalent must be calculated using an 'actuarial basis' and must represent 'the amount at the guarantee date which is required to make provision within the scheme for a member's accrued benefits, options and discretionary benefits'.

When a member requests a statement of their cash equivalent transfer value, a calculation of their cash equivalent must be made with an effective date no later than three months after the date of the request. The effective date is known as the guarantee date. Where, for reasons beyond their control, the trustees are unable to calculate the cash equivalent within the three months, the time limit may be extended for up to a further three months.

A written 'statement of entitlement' must be issued to the member within ten working days of the guarantee date, which must include a statement of the guaranteed cash equivalent and the guarantee date.

If a member exercises his/her statutory right to a transfer payment (by making a formal written application to the trustees) within three months of the guarantee date, the guaranteed cash equivalent must be paid within six months of the guarantee date.

It is essential that administrators maintain accurate records of the destinations of transfer payments. This prevents discrepancies on retirement when members attempt to trace their benefits but do not recall transfers. Administrators must also ensure they receive the relevant confirmation from the receiving arrangement, certifying that they meet the statutory criteria, to ensure that the trustees receive the statutory discharge.

4.2.6 Avoiding Transfers to 'Pension Scam' Schemes

Both the Pensions Regulator and HMRC are very concerned about the number of transfers to 'pension scam' schemes. These are schemes which, although apparently operating as normal registered pension schemes, nonetheless give members early access to their pension savings, for example in the form of a loan or cash payment, in breach of HMRC rules, or invest in highly risky investments. Such arrangements could result in the member losing most of his or her pension savings and could also result in unauthorised payment charges on the member.

The Pension Schemes Act 2021 gives help to trustees to prevent transfers where there seems to be a scam risk.

To help administrators and trustees to detect and deter such transfers, the Regulator has issued several publications (including a member booklet and a scheme transfer checklist for trustees and administrators), which are available from the regulator's website at:

http://www.thepensionsregulator.gov.uk/trustees/pension-scams-trustees.aspx.

The Regulator expects trustees and administrators to issue the member booklet to members who enquire about a transfer.

In January 2015 the Pensions Ombudsman published several determinations in connection with some pension scam cases. The cases involved transfers to schemes claiming to be occupational pension schemes and the Ombudsman's determinations included confirmation of some key points to help determine whether a member has a statutory right to a transfer in these circumstances.

In February 2016, the High Court of Justice ruled that one of the grounds on which the Ombudsman had based his decisions was incorrect. The Ombudsman had taken the view that, for a member to have a statutory right to a transfer, the member must have received earnings from an employer connected with the proposed receiving scheme. The High Court ruled that the relevant legislation only requires that the member is currently in receipt of earnings from any source.

Administrators and trustees should bear all of this in mind and any future determinations made by the Ombudsman or future High Court rulings when assessing potential pension scam transfers.

In March 2015, the Pensions Administration Standards Association (PASA) published a code of practice on due diligence, to help administrators when dealing with requests for a transfer of benefits. Although it is not obligatory for schemes to follow the code most schemes are expected to have reviewed it and if necessary, aligned their transfer out processes to reflect the PASA code.

4.2.7 Transferring Contracted Out Benefits

Where contracted out benefits are transferred on an individual basis to a former contracted out salary related (COSR) scheme willing to accept the contracted-out benefits, the receiving scheme can provide:

- either GMP and / or post 5 April 1997 contracted out benefits, or
- benefits in a different form (i.e., not in the form of GMP or post 5 April 1997 contracted out benefits) in line with the receiving scheme's transfer-in provisions

Where contracted out benefits are transferred to any other type of receiving scheme willing to accept the contracted-out benefits, the receiving scheme will provide benefits in return in line with its transfer-in provisions.

There contracted out benefits are transferred to any scheme including a former COSR scheme providing benefits in a different form, the member will need to confirm in writing to the transferring scheme that they:

- have received a statement from the receiving scheme showing the benefits to be awarded
- accept that the benefits may differ in amount and form, and
- understand that there is no requirement for the receiving scheme to provide survivors' benefits in respect of the transfer payment

The transfer payment must also be at least equal to the cash equivalent of any GMP rights the member may have held.

For transfers of contracted out benefits on or after 6 April 2016, the transferring scheme no longer has to send a notification form to NIC&EO informing them that responsibility for the contracted-out benefits now rests with the receiving arrangement. This also applies where GMPs have been converted to ordinary scheme benefits and subsequently transferred.

4.3 RECORDS FOR LEAVERS

When members leave pensionable service with an entitlement to a deferred benefit, schemes must keep additional records to those already kept during their active membership, to ensure that increases up to the date of payment are correctly applied, for example:

- if previously contracted out, increases due on GMP (pre-6 April 1997 service) and post 5 April 1997 deferred benefits
- increases due on excess benefit subject to compulsory revaluation and any fixed element, post 5 April 2005 deferred benefit (for schemes which have elected 2.5% Limited Price Indexation pension increases)

If a member transfers out or takes a refund of contributions, records must be kept of how much was paid and when and, in the case of a transfer, details of the receiving arrangement and where relevant, that the member received appropriate independent advice in connection with the transfer.

Summary

When an individual leaves pensionable service, various factors determine what benefits will be payable, if any. All leavers with at least two years' qualifying service are entitled to a preserved benefit on leaving.

Under a DB arrangement, the trustees must increase deferred pensions between the date of leaving and retirement. The rate at which they are increased depends on the type of benefit, when the member left the scheme and whether the scheme revalues pensions in line with the statutory requirements or at a higher rate.

Members may have the right to transfer the value of their benefits in any category or categories to another pension arrangement. How the transfer value is calculated is determined by The Occupational Pension Schemes (Transfer Values) Regulations 1996/1847.

If a member exercises their statutory right to take a transfer value of a particular category of their benefits the transfer must be completed within a specified timeframe. A transfer from one registered scheme to another is not a BCE.

In certain circumstances, a member must obtain appropriate independent advice about the transfer before the transfer can take place.

Self Test Questions

- Explain the rate of the tax charge payable on a refund of contributions.
- Describe when the appropriate independent advice requirement applies to a transfer out.
- Distinguish between a cash transfer sum and a cash equivalent transfer value.
- Outline how an ex-employee of Colourboxx's cosmetics-manufacturing subsidiary might be able to trace their benefits now that the scheme has been renamed The Colourboxx Cosmetics Retirement Benefits Scheme.
- Where a former COSR scheme is willing to accept contracted out benefits as part of a transfer payment, explain how the contracted-out benefits can be treated in the receiving scheme.
- Explain why the trustees of a registered pension scheme might refuse a member's request to transfer their benefits to a non-registered scheme.

Part 3

TAXATION AND GOVERNANCE OF DEFINED BENEFIT SCHEMES

OVERVIEW

This Part deals with two different but nonetheless very important aspects of the management of a DB scheme as a whole – taxation and governance.

Chapter 1 looks at the taxation of DB schemes. It sets out why nearly all DB schemes are registered with HMRC and the tax privileges this brings. It also looks at the Annual Allowance which applies to members of registered schemes and how members can in certain circumstances apply for protection from the AA. Finally, it looks at the various reports and information which Scheme Administrators of DB registered pension schemes need to provide to members and to HMRC, and at how the various benefits payable from those schemes are taxed.

Compliance with the various HMRC requirements and payment of the correct tax at the correct time is essential to avoid the risk of HMRC imposing penalties on the Scheme Administrator or on the members of the scheme.

Chapter 2 looks at the governance of DB schemes and sets out the structures which need to be in place to ensure that the scheme is operated correctly and in line with legal requirements, that members of the scheme receive the benefits to which they are entitled, and that the security of those benefits is maintained. It sets out how good governance can be achieved, the various factors involved in ensuring good governance and the roles and responsibilities of the trustees and the employer in this.

The Pensions Regulator has issued various Codes of Practice and other regulatory guidance to help trustees in their governance duties, and the chapter summarises the key guidance and the Regulator's powers which can be used to ensure that trustees manage schemes appropriately.

After studying this Part, you should have an understanding of these two key aspects of the management of a DB scheme, before you move on to look at the funding and investment aspects of DB scheme management in Part 4.

CHAPTER 1

Taxation

INTRODUCTION

An understanding of how tax relief is granted and how certain pension benefits are taxed is fundamental to the management and administration of a pension scheme. Scheme Administrators must pass a 'fit and proper person' test otherwise HMRC can refuse to register a pension scheme. Failure to register a pension scheme would mean neither the pension scheme nor the member would be able to receive beneficial tax reliefs.

The lifetime allowance, the maximum amount someone can accrue in a registered pension scheme in a tax efficient manner over their lifetime, was abolished entirely from 6 April 2024. Prior to that, the lifetime allowance charge was removed from 6 April 2023.

Some individuals have protected their accrued benefits against reductions in the standard LTA, providing them with relief from the additional tax charges if they meet the requirements of their protection.

Protections are still worthwhile. If a member applied for protection by 15 March 2023 and retained a valid LTA protection as at 6 April 2023 they will retain their entitlement to a higher Pension Commencement Lump Sum which is otherwise capped at £268,275. From 6 April 2023 members previously affected by the LTA but with protections can join new arrangements or transfer without losing their protections.

Administrators must inform their members if the value of their contributions exceeds the Annual Allowance (AA) in a tax year. The AA has been increased from £40,000 to £60,000 from 6 April 2023 following the Finance Act 2023. This means that if a member has exceeded the Annual Allowance this will be added to the rest of their taxable income for the tax year and be subject to Income Tax at their marginal rate.

To help HMRC determine how much tax should be paid by pension schemes and members, Scheme Administrators must report information to HMRC when certain events occur. This helps HMRC to reconcile any tax payments they have received and to determine when further tax may be payable.

By the end of this chapter, you should have a clear understanding as to why pension schemes are usually tax- registered, the various LTA enhancements which members may apply for, and the various reports which pension schemes may need to provide to HMRC and to members.

1.1 SCHEME REGISTRATION

Since 6 April 2006, pension schemes must be registered for tax purposes with HMRC in accordance with Chapter 2 of Part 4 of the Finance Act 2004, in order to benefit from tax relief.

Any new schemes that are established on or after 6 April 2006 have to register online for tax relief using HMRC's Pension Schemes Online service. A Pension Scheme Tax Reference (PSTR) number is issued as evidence of registration.

In October 2013, HMRC made a number of changes to the registration process to deter pension scams and safeguard pension savings. HMRC moved away from a 'process now, check later' approach with scheme registration no longer automatically confirmed on successful submission of the online form.

The revised process enables HMRC to conduct detailed risk assessment activity before making a decision on whether or not to register a scheme. The risk assessment will in many cases include writing out to the Scheme Administrator for further information. Scheme Administrators then have to submit the required information, or the application will be rejected. Only once all necessary checks have been carried out will HMRC decide whether to register a pension scheme.

There is no time limit within which HMRC must decide whether to register a pension scheme. However, if a decision hasn't been made within 6 months of the application being made, it is possible to appeal to a tribunal.

In some cases, HMRC may also need to inspect certain documents on the Scheme Administrator's premises. Where they do, HMRC will usually send a written notice to the Scheme Administrator at least seven days before the visit.

Amending legislation was introduced in the Finance Act 2014 to widen the circumstances in which HMRC may refuse to register a pension scheme, to include cases where it believes that:

- the Scheme Administrator is not a fit and proper person to fulfil that role, or
- the scheme has been established for purposes other than for providing authorised pension benefits Once a scheme is registered with HMRC, the following tax concessions will apply:
- tax relief on member contributions up to certain limits
- relief on employer contributions
- a contribution paid by an employer in respect of their employee's scheme is not taxable as earnings for the employee concerned
- certain lump sums paid to the member (such as the pension commencement lump sum) or following the member's death will not be liable to income tax
- most investment income is exempt from income tax
- gains from the disposal of scheme investments are exempt from capital gains tax

HMRC can deregister any scheme if, for example, funds were accessed illegitimately, and impose a deregistration charge. This is a very severe power that is rarely used.

If a pension scheme loses its registered status, HMRC will levy a deregistration charge on the Scheme Administrator of 40% of the scheme assets immediately before deregistration. The Scheme Administrator would need to account for, and pay, the tax due on the Accounting for Tax return (see Part 3, Chapter 1.4.2 for more information on the Accounting for Tax return).

1.2 PROTECTION AND THE LIFETIME ALLOWANCE (LTA)

From 6 April 2006, HMRC introduced a Lifetime Allowance (LTA) which applies to the value of a member's benefits when they are drawn on retirement, paid as a lump sum on death or transferred overseas. If any benefits have still not been taken when the member reaches age 75, these are also tested against the LTA. If the value of the member's benefits exceeds the LTA, a special tax charge - the Lifetime Allowance charge - applies to the benefits in excess of the LTA (see Part 3 Chapter 1.3.7 for details of the reporting requirements and Part 2 Chapter 3 for details of how the LTA works when a member takes their benefits on retirement or following their death).

Initially the standard LTA increased annually to a high of £1.8 million for 2010/11 and 2011/12 but the standard LTA was reduced under the Finance Act 2011 to £1.5 million in 2012/13. It was further reduced under the Finance Act 2013 to £1.25 million in 2014/15 and again under the Finance Act 2016 to £1 million in 2016/17.

For 2020/21 and 2021/22 the value of the LTA is £1,073,100 and remained the same for 2022/23.

The lifetime allowance, the maximum amount someone can accrue in a registered pension scheme in a tax efficient manner over their lifetime, was abolished entirely from 6th April 2024. Prior to that, the lifetime allowance charge was removed from 6 April 2023. (Finance Act 2023).

However, if a member applied for protection by 15/03/2023 and retained a valid LTA protection as at 6 April 2023 they will retain their entitlement to a higher tax free pension commencement lump sum so the protections are still important. From 6 April 2023 members previously affected by the LTA but with protections can join new arrangements or transfer without losing their protections.

1.2.1 Primary and Enhanced Protection

At 6 April 2006, there were a few individuals who had already accrued benefits with a value of over £1.5 million (which was the level of the LTA as at that date), or who expected to do so by the time they retired. HMRC allowed such members to apply to it for protection from the Lifetime Allowance charge.

The two types of protection that were initially available are known as primary protection and enhanced protection. Members wishing to apply for these types of protection had to do so by 5 April 2009.

- Primary protection is available to members who had already accrued benefits with a value greater than £1.5 million at 5 April 2006. The value of their accrued benefits as at that date (increased as set out below) is protected from the Lifetime Allowance charge. HMRC provided these individuals with an enhancement to the standard LTA.

To maintain the value of primary protection when the standard LTA was reduced from £1.8 million to £1.5 million from 6 April 2012, the enhancement to the LTA was based on the larger of £1.8 million and the standard LTA at the point the member's benefits were paid.

Example

A member had accrued benefits at 5 April 2006 which were valued at £2.1 million. This value is 40% higher than the standard LTA at that date. The member applied for primary protection and HMRC gave him/her an 'enhancement factor' of 0.4.

The member retires on 1 November 2017 when the standard LTA is £1 million but as the member has primary protection their enhanced LTA can be calculated using £1.8 million instead. As a result of the enhancement, this member's LTA will be £1.8 million x (1 + 0.4) = £2.52 million. Benefits up to £2.52 million in value will not be subject to the Lifetime Allowance charge but benefits in excess of this amount will be subject to the charge.

- Enhanced protection is available to any member, although in practice only members with benefits valued above £1.5 million at 5 April 2006 are likely to have applied for it. Under enhanced protection, a member's benefits were completely protected from the Lifetime Allowance charge.

1.2.2 Fixed Protection 2012, 2014 & 2016

As a result of the reduction in the LTA to £1.5 million from 6 April 2012 a further type of protection, known as fixed protection 2012, was introduced. Members could apply to HMRC for fixed protection 2012 if they thought that the value of their benefits would be higher than £1.5 million by the time they came to take them. Applications for fixed protection 2012 had to be received by HMRC by 5 April 2012.

Under fixed protection 2012, benefits up to £1.8 million in value are protected from the Lifetime Allowance charge, but benefits in excess of this amount were subject to the charge.

A further version of fixed protection, known as fixed protection 2014, was introduced as a result of the reduction in the standard LTA to £1.25 million from 6 April 2014. Fixed protection 2014 allows members to protect benefits up to a value of £1.5 million. Members had to apply for fixed protection 2014 before 6 April 2014.

In 2016 the latest version of fixed protection, known as fixed protection 2016, was introduced following the reduction in the standard LTA to £1 million from 6 April 2016. Fixed protection 2016 allows members to protect benefits up to a value of £1.25 million. Applications would have had to have been made by 15/03/2023.

1.2.3 Individual Protection 2014 and Individual Protection 2016

As a consequence of the reduction in the LTA from £1.5 million to £1.25 million from 6 April 2014, members could apply for a further form of protection called individual protection 2014. Under individual protection 2014 members can protect the value of their accrued benefits as at 5 April 2014, subject to a maximum of £1.5 million. Applications for individual protection 2014 had to be received by HMRC by 5 April 2017.

Following the further reduction to the standard LTA from 6 April 2016, a new version of individual protection was introduced, known as individual protection 2016. Individual protection 2016 is similar to the previous version by allowing members to protect the value of their accrued benefits as at 5 April 2016, subject to a maximum of £1.25 million. Applications would have had to have been made by 15/03/2023.

1.2.4 Evidence of HMRC protection

Where HMRC accepts a member's application for protection they will, unless the protection is fixed protection 2016 or individual protection 2016, issue a protection certificate. This will be needed as evidence whenever the member takes benefits from a scheme, to enable administrators to apply the protection to their benefits.

Where the protection is fixed protection 2016 or individual protection 2016, as members can only apply online via their 'personal tax account' in HMRC online services they will instead receive a protection reference number and a pension scheme administrator (PSA) reference as evidence of protection. In due course it is expected that pension administrators will be able to check a member's protection status online before settling benefits.

1.2.5 Finance Act 2024

Under the Finance Act 2024, the Lifetime Allowance was completely abolished from 6 April 2024. This removed the overall limit for individuals on tax-relievable pension savings.

New allowances were introduced from 6 April 2024 placing limits on the total amount of lump sums and lump sum death benefits that individuals can receive free from Income Tax:

- Lump Sum Allowance - the maximum amount of benefits an individual can take from all their pension schemes as tax-free cash. The limit is £268,275, but this may be higher if the individual holds a protected allowance.
- Lump Sum and Death Benefits Allowance - the maximum amount of benefits an individual and their beneficiaries can take from all the individual's pension schemes as a tax free lump sum. The limit is £1,073,100, but this may be higher if the individual holds a protected allowance.

When a BCE occurs, the amount of lump sum paid is tested against the individual's available allowances.

1.3 REPORTING TO MEMBERS

1.3.1 Annual Allowance

The Finance Act 2004 introduced the 'Annual Allowance' (AA), which is the maximum increase in the value of a member's benefits that can occur in each tax year before a tax charge (the 'Annual Allowance charge') arises. The allowance was initially set at a high level, but from 6 April 2011 it was significantly reduced to £50,000 and was further reduced to £40,000 from 6 April 2014.The value of the AA for 2023/24 is now £60,000.

There are some circumstances when the operation of the AA is different:

- in the summer Budget 2015, the Government announced that a Tapered Annual Allowance (see Part 3, Chapter 1.3.2) would be introduced from April 2016 for individuals with incomes over £150,000
- to allow for the introduction of the Tapered Annual Allowance, special rules were introduced for the 2015/16 tax year (see Part 3, Chapter 1.3.4)
- where the member is also subject to the Money Purchase Annual Allowance the operation of the AA is different (see Part 3, Chapter 1.3.5)

A member may be able to offset any excess increase in benefits against any unused AA from the three previous tax years. HMRC refers to this as 'carrying forward' unused AA.

1.3.2 Tapered Annual Allowance

From 6 April 2016, individuals who had income for a tax year of greater than £150,000 have their AA for that tax year restricted. For every £2 of income they had over £150,000, their AA was reduced by £1.

Anyone with adjusted income of above £210,000 would have an AA of £10,000.

Following complaints – most noticeably from consultants in the NHS – Chancellor Rishi Sunak increased the thresholds for the tapered annual allowance in the 2020 spring budget by £90,000. This means that the tapered annual allowance now affects incomes over £240,000. However, the minimum annual allowance is now £4,000 rather than £10,000.

The Finance Act 2023 again raised the income to £260,000 from 6/04/2023. The tapering stops at

£360,000. So everyone will retain an allowance of at least £10,000. The minimum allowance rose to

£10,000 from £4,000 on 6/04/2023 following the Finance Act 2023. For example, if your income was

£280,000 your AA would be £50,000. As the AA is reduced by £1 for every £2 of income over £260,000 via tapering.

As previously, any unused AA from the three previous tax years can be carried forward and added to the individual's AA. Where this AA is reduced by the taper, the carry forward will be the balance of the tapered amount.

1.3.3 Providing Information to Members in Connection with the AA

If an Annual Allowance charge is due, the member must report the excess over the AA to HMRC on their tax return.

Each arrangement in which the member has any benefits will have a 'pension input period' (PIP). This is the period across which the increase in the value of the member's benefits (the 'pension input amount') is calculated for testing against the AA.

Previously all PIPs were set by the scheme and, while they may align with the tax year, in most cases they were usually some other period, such as the scheme year. With the introduction of the Tapered Annual Allowance, all PIPs had to switch to tax years from 2016/17. To allow for this, transitional arrangements were introduced for 2015/16 (see Part 3, Chapter 1.3.4 for transitional PIPs in 2015/16).

For each tax year, the member must check whether they need to pay an Annual Allowance charge on the increase in the value of their benefits. To do this the member must compare, against the AA for that tax year, the total increase in the value of their benefits (in all registered schemes in which they participate) in that tax year. If a tax charge is due, the member may be able to ask their pension scheme to pay the charge on their behalf (see Part 3, Chapter 1.4.4).

If a member's pension input amount in one scheme exceeds the AA for that tax year, that scheme must automatically notify the member of the pension input amount for that tax year and also for the preceding three tax years. In all other cases, schemes only need to provide that information to members on request. Schemes must include details of pension input amounts provided automatically and the members to whom they were provided on the scheme's event report (see Part 3, Chapter 1.4.5).

Schemes must therefore hold sufficient data to calculate members' pension input amounts under the scheme and be able to provide this information to members and to HMRC.

1.3.4 Transitional PIPs for 2015/16

To allow for the introduction of the Tapered Annual Allowance all pension input periods (PIPs) needed to be aligned with the tax year from 2016/17 onwards. This alignment applies to all schemes and members, not just to high earners affected by the Tapered Annual Allowance.

To align PIPs with the tax year the Government introduced special rules for PIPs ending in the 2015/16 tax year:

- all PIPs open on 8 July 2015 (the day of the summer 2015 Budget, on which the changes were announced) ended on that date
- the next PIP ran from 9 July 2015 to 5 April 2016 (i.e., to the end of the tax year)
- all subsequent PIPs match the tax year

These special PIPs for 2015/16 applied to all schemes, even if the scheme's PIP was already based on the tax year. These changes meant that all members accruing benefits in the 2015/16 tax year had at least two PIPs in the tax year. If a PIP had already ended between 6 April and 8 July 2015, the member had three PIPs.

In turn, this meant that special rules also applied to the calculation of pension input amounts (PIAs) and to the AA in 2015/16. Everyone had an AA of £80,000 for PIPs that ended in the period between 6 April 2015 and 8 July 2015, plus any available carry forward. However, for the PIP from 9 July 2015 to 5 April 2016 individuals only had an AA of up to £40,000 plus remaining carry forward from 2014/15, 2013/14 or 2012/13.

1.3.5 Money Purchase Annual Allowance

From 6 April 2015 a Money Purchase Annual Allowance (MPAA) of £10,000 applies to all future money purchase contributions once a member has accessed any DC funds flexibly. The MPAA has been reduced to £4,000 with effect from 6 April 2017 and had remained at the same level ever since. Following the Finance Act 2023 it has risen to £10,000 again from 6 April 2023.

The MPAA runs alongside the existing AA (currently £60,000 in 2023/24), which will still apply for aggregated savings from both DB and DC arrangements. How this works will depend on whether the member has exceeded the MPAA in the tax year:

- if a member has exceeded the MPAA in the tax year (i.e., the DC contributions made by them and on their behalf exceed £10,000):
  - they will be subject to the Annual Allowance charge on the excess over £10,000 on the DC contributions, and
  - the residual AA for the rest of their pension savings will reduce to £50,000 (plus any unused AA that has been carried forward). Any savings tested against the £10,000 MPAA will not be tested against the reduced £50,000 AA
- if the member has not exceeded the MPAA in the tax year (the DC contributions made by them and on their behalf are no more than £10,000), their total AA for the aggregate of DB and DC arrangements will continue to be £60,000 (plus any unused AA carried forward)

Unlike the main AA, members cannot carry forward any unused MPAA.

Special rules exist for applying the MPAA for the tax year in which the member first flexibly accesses any of their benefits. There were also special rules for the tax year 2015/16, where in some circumstances a higher MPAA of £20,000 applied.

1.3.6 Providing Information to Members about the MPAA

The first time a member accesses any of their DC funds flexibly, the Scheme Administrator must normally provide a statement to the member within 31 days of the event explaining that as the member has accessed their pension rights flexibly the member is now subject to the MPAA. The member must then notify all other DC arrangements in which they are an "accruing member" that they have received this statement and that they have accessed their pension rights flexibly. The member must do this within 91 days (i.e., 13 weeks) of receiving the statement.

1.3.7 Overseas Transfer Charge and Overseas Transfer Allowance

Pension transfers from a qualified recognised overseas pension scheme (QROPS), or former QROPS, to another QROPS may be liable to an overseas transfer charge of 25% of the amount that's being transferred.

Overseas Transfer Allowance

The Finance Act 2024 introduced the Overseas Transfer Allowance, effective from 6 April 2024. The overseas transfer charge does not apply to the transfer if the member has sufficient available Overseas Transfer Allowance and the scheme member has provided information in advance of the transfer which shows:

- they're a resident of the country that the QROPS receiving the transfer is based in
- they're a resident of the UK, Gibraltar or a country in the European Economic Area (EEA) andthe QROPS is based in Gibraltar or an EEA state
- the QROPS is an occupational pension scheme and the member is an employee of asponsoring employer under the scheme at the time of the transfer
- the QROPS is an overseas public service scheme and the member is employed at the time oftransfer by an employer that participates in that scheme
- the QROPS is a pension scheme of an international organisation and the member is employedat the time of transfer by that international organisation

Overseas Transfer Charge

The overseas transfer charge can apply to transfers requested on or after 9 March 2017:

- that include funds that came from a transfer (known as the original transfer) from:
- a registered pension scheme
- an overseas pension scheme where the member's pension funds have received UK tax relief
- where the transfer from the QROPS (or former QROPS) is made within five full tax years ofthe original transfer into the scheme
- where the member has exceeded their overseas transfer allowance

The overseas transfer charge does not apply to the part of a transfer that includes pension savings:

- held under the scheme before 9 March 2017
- where the overseas transfer charge was paid on a previous transfer (and has not been refunded by HMRC)

Disclosure Requirements

For all overseas transfers paid on or after 9 March 2017, the Scheme Administrator must provide the member with the following information within 90 days of the date of the transfer:

If the overseas transfer charge applied:

- the date of the transfer
- the fact that the overseas transfer charge applied to the transfer
- the transfer value (after the deduction of any LTA charge (transfers prior to 6 April 2023 only) but before any deduction for the overseas transfer charge)
- the amount of the overseas transfer charge and the excess over the Overeas Transfer Allowance
- whether/to what extent the Scheme Administrator has accounted for the tax to HMRC or intends to do so
- in the event that the Scheme Administrator has already accounted for tax to HMRC, the date they did so

If the overseas transfer charge did not apply:

- the date of the transfer
- the fact that the transfer was not chargeable to tax
- why the transfer was not chargeable and any actions that will mean the transfer subsequently becomeschargeable, including the percentage of Overseas Transfer Allowance used up by the transfer

If the overseas transfer charge is repaid to the Scheme Administrator of a UK registered pension scheme, the Scheme Administrator must within 90 days after the date of repayment provide the member with a notice stating:

- the date of the repayment
- the amount of the repayment, and
- the reason for the repayment

1.4 CHARGES AND REPORTING TO HMRC

Scheme Administrators of registered pension schemes and sponsoring employers must provide information to HMRC in certain circumstances. Insurance companies may also be required to do the same, as if they were the Scheme Administrator. The obligation to provide information can take various forms:

- the mandatory provision of information without first being asked by HMRC
- provision of information during an HMRC pension scheme inspection
- provision of documents or information in response to a notice from HMRC
- the preservation of particular documents

Failure to provide information in accordance with HMRC legislation or in response to a notice, or providing false information, can result in penalties.

Scheme Administrators are responsible for deducting and accounting for tax on pensions and certain other authorised payments made from the scheme. In addition, if they make any unauthorised payments, they will be liable to a tax penalty based on the amount of the unauthorised payment.

As well as accounting for tax by sending tax returns, Scheme Administrators must submit an annual event report to HMRC giving details of prescribed events (see Part 3, Chapter 1.4.5). This event report must be submitted automatically by all schemes that have any reportable events and is required in addition to any tax return that the Scheme Administrator may be required to provide.

Although the rate of the tax charge varies, all of the charges described below are classed as income tax.

1.4.1 Taxation of Authorised Payments

We will look at the taxation of authorised payments under two headings:

- pensions, trivial commutations, certain lump sum death benefits, certain serious ill health lump sums and uncrystallised funds pension lump sums which are taxed under Pay-As-You-Earn (PAYE)
- other authorised payments, where tax is charged on the Scheme Administrator when the payments are made

PAYE: Taxation of Pensions, Trivial Commutations, Lump Sum Death Benefits (LSDBs) and Uncrystallised Funds Pension Lump Sums Pensions

The pension payroll could be operated by:

- the employer's accounts department
- the administrator (in house or outsourced)
- an external bureau

Whoever is responsible for the pension payroll must operate the normal PAYE procedures on pensions in payment. They must report details of pension payments and tax deductions to HMRC in 'real time' on or before payments are made. Information is passed to HMRC using the Government Gateway or Electronic Data Interchange.

Tax will be deducted at source based on a coding notified by HMRC or provisionally on an emergency code. The income tax deducted must be paid to HMRC by the 19th of the month (22nd if paying electronically) immediately following the end of the month in which the tax was deducted.

P60 forms are issued to pensioners once each tax year showing the gross amount of pension paid in the past tax year and the amount of income tax deducted.

Trivial Commutations

If any pension is commuted for a cash sum on grounds of triviality, income tax must also be deducted at source under PAYE. This applies whether or not the pension is already in payment. If the cash sum is in respect of a member's pension which has not yet come into payment, 25% of the cash sum can be paid tax- free, with the remaining 75% being subject to tax. In all other cases, the whole amount is subject to tax.

Unless the pension is already in payment, PAYE deductions from trivial commutation payments are calculated using the basic rate code rather than the member's own tax code. Details of trivial commutation payments made, and tax deductions must also be reported to HMRC in 'real time'.

Lump Sum Death Benefits (LSDBs)

If a LSDB is paid following the death of a member on or after age 75 or if the LSDB is a defined benefit or uncrystallised funds LSDB paid outside of the two-year period (see Part 2 Chapter 3.2.5), tax is charged under PAYE at the marginal rate of the recipient.

Serious Ill Health Lump Sums

If a lump sum is paid in commutation of a member's entire benefits because he/she is in serious ill health, and the payment is made on or after the date the member reaches age 75, tax is charged under PAYE at the member's marginal rate.

Uncrystallised Funds Pension Lump Sums (UFPLS)

A UFPLS payable from DC benefits is subject to tax which is deducted at source under PAYE.

- 25% of the UFPLS will be paid tax-free
- 75% will be taxable as pension income at the member's marginal rate

If the Scheme Administrator does not know the member's tax code, the taxable portion of the UFPLS would be taxed using emergency code, with the member reclaiming any overpaid tax from HMRC.

1.4.2 Taxation of Other Authorised Payments

Scheme Administrators are liable to income tax if they make any of the following payments:

- contribution refunds for members who do not qualify for a preserved benefit on leaving. Tax is charged at 20% on any amount up to and including £20,000, and at 50% on any amount in excess of £20,000
- a transfer to a qualifying recognised overseas pension scheme which is subject to the overseas transfer charge of 25% of the transfer value
- taxable lump sum death benefits not paid to an individual. Although tax is generally charged under PAYE using the recipient's marginal rate, in certain circumstances (e.g., if making payment to certain trusts) a 45% tax charge will apply

Normally the tax will be deducted from the lump sum or benefits due, so that members or beneficiaries receive net benefits. However, unless the tax is an overseas transfer charge, this is not compulsory – the scheme could instead pay the tax out of its own funds so that the member or other recipient receives the gross amount.

Scheme Administrators must submit a quarterly Accounting for Tax return to HMRC if they have any tax to pay. The returns cover designated three-month periods ending on 31 March, 30 June, 30 September and 31 December. The return, together with any tax due, must be submitted to HMRC within 45 days after the end of the quarter. HMRC will levy penalties for late returns, for failing to take reasonable care when completing the return and for deliberate understatement of tax.

1.4.3 Taxation of Unauthorised Payments

If a scheme makes an unauthorised payment, both the scheme and the recipient will be subject to tax charges as follows:

- the person receiving the unauthorised payment will be taxed at 40% (and in some cases 55%) of the amount of the payment
- the scheme making the payment will also have to pay tax of 40% of the unauthorised payment. This is called the scheme sanction charge. However, this is reduced to 15% if the person receiving the unauthorised payment has paid their tax charge to HMRC by the time HMRC comes to issue the tax invoice to the scheme

The tax can be paid in one of two ways:

- the scheme can make the payment gross, without deduction of tax. Both the scheme and the recipient must then report the payment to HMRC. Once HMRC has processed these reports they will issue an invoice for the tax due
- as an alternative, HMRC allows the scheme to pay the recipient's unauthorised payment charge on their behalf, by deducting the charge from the unauthorised payment and then sending the tax to HMRC. By doing this the scheme can ensure that the scheme sanction charge will be at 15%. The recipient of the payment must sign a mandate authorising the scheme to deduct the tax if this approach is to be followed Unauthorised payments must be reported
to HMRC on the event report (see Part 3, Chapter 1.4.5).

1.4.4 Settlement of Member's Liability for Annual Allowance Charge – 'Scheme Pays'

The reduction in the AA from 6 April 2011, the further reduction from 6 April 2014 (see Part 3, Chapter 1.3.1) and the introduction of the Tapered Annual Allowance (see Part 3, Chapter 1.3.2) has meant that many more members are potentially subject to the Annual Allowance charge. These charges could be significant, and members affected may find it difficult to pay them out of their current income or savings.

HMRC has, therefore, introduced legislation requiring the member's pension scheme to settle the member's liability for this charge if requested, provided that the charge exceeds £2,000 and the member's pension input amount in that scheme exceeds the standard AA of £60,000. This is known as 'scheme pays'. The scheme must reduce the member's benefits to reflect the charge paid.

A member wishing to make use of scheme pays must make an irrevocable election and send it to the scheme no later than the second 31 July following the end of the tax year to which the charge relates. The scheme must then account for the tax to HMRC on the Accounting for Tax return no later than the following 31 December.

For example, if the charge relates to the 2019/20 tax year, the member must make their election by 31 July 2021 with the scheme accounting for the tax no later than on the Accounting for Tax return for the quarter ending 31 December 2021.

A scheme may also pay an Annual Allowance charge voluntarily on a member's behalf even though they are not obliged to do so under HMRC legislation, but the deadline for any voluntary payments is 31 January following the end of the tax year to which the charge relates.

Where a member becomes liable to an Annual Allowance charge as a result of exceeding the MPAA, they do not have a statutory right to use scheme pays to settle this tax charge, although the pension scheme may allow members to use scheme pays on a voluntary basis.

1.4.5 Event Reports

The Scheme Administrator must provide an event report to HMRC giving details of certain events (which are set out in legislation and in the Pensions Tax Manual - PTM) that have occurred during the tax year to which the report relates. With one exception, the event report must be submitted to HMRC no later than 31 January after the end of the tax year to which it relates. A shorter deadline applies if the scheme has completed winding up. No report is required if there have been no reportable events.

The exception relates to transfer payments made to qualifying recognised overseas pension schemes. Schemes must report any such transfers to HMRC within 60 days of payment.

HMRC will impose a penalty on the Scheme Administrator of up to £300 if an event report is not submitted or is submitted late. Additional penalties of up to £60 per day can be imposed if there is further delay.

Examples of events that must be reported on the event report include the following:

- certain changes to the scheme, for example if the scheme becomes, or ceases to be, an occupational pension scheme
- unauthorised payments
- pension commencement lump sums of more than 25% of the member's rights,
- pension commencement lump sums where reliance is made on enhanced or primary protection
- serious ill health lump sums for directors or persons related to the sponsoring employer

The Pension Schemes Act 2021 has tightened things up, with greater penalties being made available to the regulator and the introduction of a type of new "super" notifiable event. Penalties for Non-Compliance Where a person (generally speaking, the employer or trustee) fails to take reasonable steps to ensure compliance with the notifiable events regime, the regulator will now be able to issue a fine of up to £1 million. Additionally, any person who knowingly or recklessly provides false information to the regulator in connection with a notifiable event will now be guilty of an offence, risking an unlimited fine and up to two years in prison.

Summary

Pension schemes have to register with HMRC in order to obtain tax relief. Since October 2013 the registration process has become more stringent to deter pension scams. If a pension scheme is deregistered the Scheme Administrator must pay a 40% tax charge on all of the scheme's assets.

Schemes must provide information about the Annual Allowance to members in certain circumstances. If a member becomes subject to the Money Purchase Annual Allowance, both the pension scheme and the member have specified reporting responsibilities. If benefits are transferred to a qualifying recognised overseas pension scheme, Scheme Administrators must provide information about the overseas transfer charge.

Payments by pension schemes are either authorised or unauthorised payments. All unauthorised payments are subject to tax charges which are levied against both the recipient and the scheme. Most authorised payments are also subject to tax charges, either under PAYE or at specified tax rates.

Schemes must submit a quarterly Accounting for Tax return to HMRC if they have made any taxable authorised payments that are not taxed under PAYE. Schemes must also submit an annual event report to HMRC if any reportable events, including any unauthorised payments, have occurred during the tax year. Schemes also need to report to HMRC any transfers to qualifying recognised overseas pension schemes within 60 days of payment.

Self Test Questions

- Explain why a pension scheme would register with HMRC and how the registration process works.
- Distinguish between enhanced protection, primary protection, fixed protection 2012, fixed protection 2014, fixed protection 2016, individual protection 2014 and individual protection 2016.
- Describe the information that a scheme must provide to a member whose pension input amount under the scheme exceeds the Annual Allowance for the tax year.
- List the information that a scheme must provide to a member if an overseas transfer is made.
- Distinguish between the taxation treatment of authorised and unauthorised payments.
- Describe the various reports that schemes may have to make to HMRC in connection with the scheme's tax liabilities.

CHAPTER 2

Governance

INTRODUCTION

This chapter considers the governance of DB schemes and the various elements which interact to create a governance structure including the legal framework; the roles of the employer, the trustees, and the Pensions Regulator, and what constitutes good governance and best practice.

Governance does not apply exclusively to pension schemes. Codes of governance apply in many areas including corporate governance for private companies, in the public and health sectors and for voluntary and charitable organisations. It is generally accepted that a robust governance structure brings many advantages for the organisation concerned including greater effectiveness and the ability to manage risk in a structured way.

So, what is 'governance' and how is it defined? It is possible to find a number of definitions and in some respects the concept of what is needed to achieve good governance can sometimes be difficult to pin down. Put very simply, good governance involves the implementation of an appropriate framework of principles, guidelines, and processes for successfully running a pension scheme. An effective governance structure enables the achievement of superior performance.

An understanding of what governance is and how good governance can be achieved is important given the complex issues and responsibilities which face the trustees and sponsors of DB schemes. By the end of this chapter, you should have a broad understanding of the various factors involved and the roles and responsibilities of the trustees and the employer.

2.1 THE LEGAL FRAMEWORK

2.1.1 Trust Law

DB schemes operated by private sector employers are nearly always set up under trust. This is a very old legal structure under which one party (the employer) gives the trust's assets to another party (the trustees) to be used only for the benefit of a third party (the scheme members). There is a complex body of legislation and case law which underpins the operation of pension schemes of this type. The benefits which are to be provided and many of the rules by which a scheme is managed are set out in a legal document - the Trust Deed and Rules - which should normally be the first point of reference for any question relating to the scheme.

The trustees are responsible for the management of the scheme. Although they can use their powers to delegate some functions, the trustees still retain accountability. The Pensions Regulator sets out the key duties of a trustee as follows:

Act In Line with the Trust Deed and Rules

The Trust Deed and Rules, together with pensions legislation, tell the trustees what their powers are and the procedures they must follow. They are important documents and, therefore, trustees must be familiar with them and with the other documents governing the scheme.

Act Prudently, Responsibly and Honestly

Trustees must act in a way that an ordinary prudent person of business would act in managing their own affairs. This means, for example, that when deciding whether to exercise a power, the trustees must consider the circumstances impartially, having taken account of all the relevant facts, and must ask for professional advice if necessary.

Act in the Best Interests of the Beneficiaries

Trustees must act in the best interests of the scheme's beneficiaries. A beneficiary is anyone who is entitled to, or who might receive, a benefit from the scheme, now or in the future.

Act Impartially

Trustees must consider the interests of all the classes of beneficiary covered by the Trust Deed and Rules, and act impartially. Trustees must act fairly between individual beneficiaries too, weighing the interests of the particular individual against the need to protect the security of the beneficiaries as a whole. Acting impartially does not mean that each type of member needs to be treated in the same way. But it does mean that the trustees will need to weigh the differing interests of different members against each other.

In making decisions about the scheme either in respect of an individual member or for the scheme as a whole, the trustees must have regard to their duties but must also work within the requirements of the scheme's legal documentation and any appropriate legislation and regulation. This can give rise to many complex situations and there is a need for the trustees to be appropriately knowledgeable and to have access to a number of advisers to assist them on an ongoing basis (see Part 3, Chapter 2.5.7).

2.1.2 Pensions Law and Regulation and Other Applicable Legislation

Following the death of Robert Maxwell in 1991 it was discovered that he had plundered the pension fund operated by the Mirror Group to shore up the company and a major review of the operation of pension schemes was undertaken. This gave rise to the Pensions Act 1995 and subsequently the Pensions Act 2004, both of which codify aspects of trust law and contain additional powers and duties for pension scheme trustees.

There are now a number of legal and other provisions which impact significantly on the way in which pension schemes are governed including the following statutory requirements:

- to appoint member nominated trustees which for most schemes means that at least one-third of the trustee board must be appointed by the scheme membership
- the requirement for the trustees to appoint certain advisers which for a DB scheme means that both a Scheme Actuary and an auditor must be appointed

- a statutory funding regime (see Part 4, Chapter 3) which includes a requirement for the trustees and employer to formally agree the level of contributions which will be paid by the employer over a prescribed period
- a requirement to manage conflicts of interest (see Part 3, Chapter 2.5.5)
- a requirement for the trustees to produce a Statement of Investment Principles (see Part 4, Chapter 6.11) which sets out their policy with regard to the investment strategy for the scheme
- a requirement that the trustees maintain adequate internal controls
- a requirement that the trustees have the appropriate knowledge and skills to carry out their role (the Trustee Knowledge and Understanding (TKU) requirements)
- a duty which applies to the trustees, the employer, advisers and various other parties to report breaches of the law to the Pensions Regulator (whistleblowing)
- prescribed requirements in terms of the disclosure of information to members
- requirements relating to record keeping (see Part 2, Chapter 1.3) and data protection
- for the employer to put in place appropriate arrangements to comply with the automatic enrolment requirements and to consult with members if certain changes are proposed in respect of their benefits These legislative changes have introduced numerous provisions which are intended to protect the rights of members and have resulted in fundamental changes to the way in which pension schemes are now governed.

2.2 MANAGING A DB SCHEME – THE RESPONSIBILITIES AND ROLES OF THE EMPLOYER AND THE TRUSTEES

The governing documentation for a scheme is divided into two parts; the Trust Deed which establishes the trust and sets out the respective powers of the trustees and the employer in operating the scheme, and the Rules which set out details of the benefits which are to be provided. The employer will initially have

set up the scheme and therefore will have had a major influence on both parts of the document. However, once a scheme has been established, it will largely be managed by the trustees and good governance will depend on the effectiveness of the trustee body.

The term 'balance of powers' is often referred to and this relates to the powers of the employer and the trustees as set out in the Trust Deed and Rules and any overriding legislation. No two schemes are identical, but the following are some examples of requirements which are typically found within the documentation of many pension schemes:

- the power to appoint trustees normally rests with the employer subject to the overriding requirements relating to member nominated trustees
- the Trust Deed will set out the basic rules for managing trustee meetings and making trustee decisions
- the trustees will determine the contribution requirements for the scheme but will consult and agree the details with the employer under the statutory funding requirements
- the trustees are responsible for the investment strategy under the scheme and for preparing the Statement of Investment Principles but are required to do this having consulted the employer. The trustees are also responsible for appointing the investment manager
- the power to appoint advisers falls on the trustees and in some cases, there is a statutory requirement associated with this (the Scheme Actuary and the auditor)

- the trustees are responsible for administering the scheme
- the trustees will be responsible for calculating each member's benefits at the appropriate time and for communicating information to members in accordance with the relevant disclosure requirements
- the employer would normally have the power to change the future benefits provided by the scheme, subject to consulting with current members in certain circumstances
- more specifically, the employer would normally have the right to close the scheme to new members or to cease the future accrual of benefits
- the employer would normally have the power to initiate a potential wind up of a scheme, although it is often the trustees which have the final say as the Trust Deed of most schemes would alternatively allow them to operate the scheme as a closed arrangement
- if there is any surplus at the point a scheme is wound up (a relatively uncommon situation nowadays), the decision as to how this can be used might fall on the trustees, the employer or both
- the power to augment (improve) members' benefits usually falls on the employer
- the power to exercise certain discretions under the scheme with regard to members' benefits would normally fall on the trustees
- the trustees are responsible for the membership data used by the scheme and will be registered as the Data Controller for Data Protection Act purposes

2.3 THE ROLE AND OBJECTIVES OF THE PENSIONS REGULATOR

The Occupational Pensions Regulatory Authority (OPRA) was established by the Pensions Act 1995 and was replaced by the Pensions Regulator from 6 April 2005 under the terms of the Pensions Act 2004.

At the same time, the Pension Protection Fund (PPF) was founded by the Government to provide certain levels of compensation in situations where a pension scheme is underfunded, and the employer becomes insolvent (see Part 4, Chapter 3.9).

The Pensions Regulator is the UK regulator of work-based pension schemes and has certain objectives set out in legislation as follows:

- to protect the benefits of members
- to promote, and to improve understanding of the good administration of work-based pension schemes
- to reduce the risk of situations arising which may lead to compensation being payable from the PPF
- to maximise employer compliance in relation to the automatic enrolment requirements
- to minimise any adverse impact on the sustainable growth of an employer (in relation to the exercise of the regulator's functions under Part 3 of the Pensions Act 2004 (scheme funding) only)

The regulator works with a wide range of bodies and organisations including trustees, employers and advisers, giving guidance on what is expected of them. It has developed a large volume of guidance in a number of formats, and it is worth visiting its website

http://www.thepensionsregulator.gov.uk/about-us.

to gain an understanding of the range of material which is available.

The regulator has a number of statutory powers, including the ability to obtain information about schemes, and is able to take regulatory action where it decides that this is required to protect the security of members' benefits. This includes the following:

- to issue an improvement notice to individuals or companies, or a third-party notice, requiring specific action to be taken within a certain time
- to take action, on behalf of a scheme, to recover unpaid contributions from the employer if the due date for payment has passed
- where wind up is pending and members' interests may be at risk, to issue a freezing order
- to prohibit trustees who the regulator does not consider to be fit and proper persons for the role
- to impose fines where breaches have occurred
- to prosecute certain offences in the criminal courts
- Additional powers have been added by The Pension Schemes Act 2021
- Inspection and Interview Powers. The regulator has been granted enhanced inspection and interview powers to support its existing information gathering powers under section 72 of the Pensions Act 2004. It will be easier for the regulator to require anyone connected with the running of a pension scheme, or a scheme employer, to attend for interview. Failure to attend for interview will be a criminal offence carrying a maximum penalty of up to £5,000. He regulator could, instead, issue a fixed penalty notice of up to £50,000 or an escalating penalty notice with a daily rate of up to £10,000.

The regulator also has power to act where it believes that an employer is deliberately attempting to avoid their pension obligations, leaving the PPF to pick up their pension liabilities. To protect the benefits of scheme members, and to reduce the PPF's exposure to claims for compensation, the regulator may issue any of the following:

- Contribution notices - these allow the regulator to direct that, where there is a deliberate attempt to avoid a statutory debt, those involved must pay an amount up to the full statutory debt either to the scheme or to the board of the PPF
- Financial support directions - these require financial support to be put in place for an underfunded scheme where the regulator concludes that the sponsoring employer is either a service company or is insufficiently resourced
- Restoration orders - if there has been a transaction and the regulator believes that a scheme's funds have been removed inappropriately, this would allow the regulator to take action to have the assets (or their equivalent value) restored to the scheme

Given the number of schemes under its remit, the regulator is not able to monitor all pension arrangements completely and it has developed a range of approaches for influencing the behaviour of trustees, employers, and advisers. It also uses the threat of its enforcement powers more widely than taking the actions themselves.

As well as Codes of Practice (see Part 3, Chapter 2.4.1), the regulator has also published the web-based Trustee Toolkit which is available as a means of providing education to trustees and to assist them in meeting the Trustee Knowledge and Understanding (TKU) provisions.

The regulator carries out various surveys and research on a regular basis with respondents taken from its scheme registry database.

During 2015 and 2016 the regulator carried out surveys on the Trustee Landscape which examined the ability of pension scheme trustees to effectively fulfil their roles. The results from these surveys were used to inform the regulator's "21st century trusteeship and governance" discussion paper, which sets out what the regulator is doing to educate and support trustees and what more could be done to raise standards.

2.4 CODES OF PRACTICE AND RELATED GUIDANCE

2.4.1 Documents Issued by the Pensions Regulator

To date the regulator has issued a number of Codes of Practice and guidance documents to assist trustees, employers, and their advisers in the operation of their Pension schemes. One of the most recent Codes of Practice was code of practice 16 – Collective Defined Contribution which came in to force on 1 August 2022. The Code of practice on the authorisation and supervision of collective defined contribution (CDC) schemes.

Although these may relate to specific legal requirements, the documents themselves are not statements of the law. In this respect it is not necessary for all aspects of the Code or guidance to be followed and alternative approaches to those outlined are possible, although a penalty may be imposed if the underlying legal requirements are not complied with. In addition, when determining whether the legal requirements have been met, a court or tribunal must take any relevant provisions of a Code of Practice into account.

Specific comments on the Codes of Practice on Internal Controls and Trustee Knowledge and Understanding are set out below. These are both key elements of the requirements which apply to all trustees and since their introduction have had a major impact on the governance structures of individual pension schemes.

Internal Controls

In November 2006 the Pensions Regulator published its Code of Practice on Internal Controls. This is supported by detailed guidance, which was published in June 2010, building on an earlier version issued in February 2007.The Code of Practice and the guidance are not prescriptive, but recommend a risk management approach as a means of meeting the requirements set out in The Occupational Pension Schemes (Internal Controls) Regulations 2005/3379.

In December 2015 the regulator issued new guidance for trustees and employers which set out an integrated risk management (IRM) framework for managing the risks associated with scheme funding for DB schemes. The guidance provides practical help on what an IRM approach might look like and is covered in more detail in Part 4, Chapter 3.3. It also links in with the more general internal controls requirements and is viewed by the regulator as forming an important part of scheme governance.

Students should review the Code of Practice on Internal Controls, the supporting guidance (and the guidance covering IRM) and example documents as part of their learning for this subject as this is one of the central elements of the governance structure which should be put in place by trustees.

The publication of the Code of Practice on Internal Controls and the supporting guidance heightened trustee awareness of the need for good governance. Previously, trustees might have seen their role as responding reactively to events and reports, but the regulator has encouraged them to be more proactive in the way that they monitor the management and administration of their scheme, and in making sure that those providing services to them carry out their responsibilities properly.

Similarly, the regulator sees itself as having a proactive role. In doing so, the regulator takes a risk-based approach, rather than focusing narrowly on whether a scheme meets a list of prescribed requirements. The challenge for trustees is how to keep on top of all the different risks that their scheme faces and – as part of this – how to ensure in each area that the regulator would not have concerns if it ever needed to look at their scheme. The way that many trustee boards do this, in line with the regulator's guidance, is to operate a risk register as explained in Part 3, Chapter 2.5.6.

Trustee Knowledge and Understanding

Sections 247 and 248 of the Pensions Act 2004 require that pension scheme trustees must have knowledge and understanding of law and practice relating to pensions and must be conversant with the documents of their pension scheme. This is a fairly wide topic, and the following is only a brief summary.

- Knowledge and understanding – the requirement in the Pensions Act 2004 is, perhaps deliberately, phrased in a very general way. This is supported by a Code of Practice that was published in November 2009 and three 'scope documents' setting out the areas in which the Pensions Regulator expects trustees to have knowledge and understanding. The lists of topics set out in the scope documents are helpful for trustees in assessing whether there are gaps in their knowledge and understanding
- Conversance with scheme documents – again, the Pensions Act 2004 does not specify exactly what steps trustees need to take to familiarise themselves with their scheme documents. The scheme's primary document, the Trust Deed and Rules, will normally be too long for most trustees to know all the detail in full but the regulator expects trustees to have a 'working knowledge' of the documents, so that they know where to look in the documents when faced with a particular issue

Maintaining knowledge and understanding goes hand in hand with making sure that the trustees have the right governance framework in place.

2.4.2 The Code of Practice on Incentive Exercises

An incentive exercise is where an employer offers scheme members a financial inducement (such as an enhanced transfer value) to transfer their benefits out of a DB scheme or to accept a reduction in benefits under the scheme (e.g., to give up their right under a scheme's rules to pension increases in excess of the statutory minimum). From the employer's perspective, this has the advantage of reducing the value of the scheme's liabilities and the risks and future uncertainty associated with funding those liabilities.

The original version of the Code was issued in 2012. Following the 2014 Budget announcement relating to pensions and the various pension flexibilities which came into effect from 6 April 2015, it was recognised that the changes were likely to have an impact on incentive exercises and version 2 of the Code applies from 1 February 2016.

Incentive Exercises for Pensions: A Code of Good Practice, version 2 January 2016 - available at

incentive-exercises-industry-code-of-practice.pdf

2.5 GOOD GOVERNANCE AND BEST PRACTICE FOR TRUSTEES

When considering what represents good governance for a scheme, it has to be recognised that 'one size does not fit all'. Each scheme and sponsor will be different and will have a multiplicity of factors to take into account when setting up a governance framework appropriate for their circumstances. However, trustees should consider the following key principles of good governance:

- professional and motivated trustee board with clear delegations, committee structure and roles and responsibilities
- appropriate policies setting out a clear strategy and beliefs and how to implement.
- transparent accountability of all involved parties, minimising conflicts of interest arising from agency issues
- regular review of scheme performance, review of structure and processes
- formal information flows and communication channels enabling timely and reliable sharing of information The legal obligations which apply to trustees and the various initiatives from the regulator as described earlier in this chapter are all aimed primarily at the protection of members' interests and achieving good member outcomes whilst recognising the business position of the employer. With these objectives in mind the following should be taken into account when putting in place a suitable governance framework for a pension scheme.

2.5.1 Governing Trust Body and the Appointment of Trustees

There is a legal requirement that (with certain exceptions) at least one-third of the trustees must be member nominated as opposed to being company appointed trustees.

The issues being considered by trustees are becoming increasingly complex and this leads to significant responsibilities. This therefore means that the effectiveness of the individual trustees (both member nominated, and employer appointed) is of great importance. So, it is necessary to have an appropriate process in place to identify and appoint trustees and this process should include minimum suitability standards in order to ensure a high level of integrity, competence, experience, and professionalism in the governance of a scheme. For member nominated trustees (and also employer appointed) the process could, for example, include an interview process with set criteria or at the very least making sure that candidates fully understand what will be required of them.

There is also an increasing trend for at least one of the trustees on the trustee board to be an independent trustee, who has no connection to the sponsoring employer. Independent trustees are often professionals who are paid for their services.

The governing body should collectively have the necessary skills and knowledge to oversee all the functions performed by the scheme.

2.5.2 Trustee Knowledge and Training

All trustees are subject to the TKU requirements already described (Part 3, Chapter 2.4). The regulator strongly recommends that trustees should review their own knowledge and understanding at least annually against the scope guidance and undertake learning to fill any gaps that this reveals. Newly-appointed individual trustees have a period of six months from the date of appointment as trustees to complete the required learning.

Many trustees carry out an analysis of their training needs taking into account the TKU requirements and any specific activities which are currently being undertaken so that targeted and specific training can be provided on an ongoing basis. It is also common for the regulator's web-based Trustee Toolkit to be used particularly for new trustees as this is a good way for them to become familiar with a wide range of pensions issues.

It is good practice for trustees to maintain a log of the training which has taken place so that they can demonstrate that they are taking appropriate action and to assist them in regularly reviewing their requirements in this important area.

2.5.3 The Management of Trustee Meetings

The effective management of trustee meetings is important as there will be a wide range of functions which the trustees are responsible for, and which need to be handled both as part of regular meetings and in the intervening periods when decisions may still need to be made. The input of the trustees' professional advisers is likely to be needed for most meetings and a good scheme secretary is essential for effectively run meetings.

Many trustee boards also appoint sub-committees (for example, to manage administration or investment matters) which assist in the efficiency of the trustee body overall and in the effective management of the trustees' workload. It is important to remember, however, that all trustees have a legal responsibility for the decisions made regardless of whether they are a sub-committee member or not.

2.5.4 Measuring Performance

An increasing number of trustee bodies are measuring the performance of the trustees individually and collectively. This can be done by carrying out effectiveness reviews which cover the operation of the trustees themselves and also that of their advisers and administrators. These exercises, if carried out successfully, can identify key areas for improvement. They can either be carried out by the trustees themselves or by a third party and can range from informal discussions to more sophisticated processes involving trustee questionnaires, trustee interviews and documentation reviews.

2.5.5 Management of Conflicts of Interest

The regulator has at various times emphasised the importance of addressing any potential or actual conflicts of interest on the trustee board and has issued guidance to assist with this important area. The most high-profile example would be a senior employee of the sponsoring company (for example, the Finance Director or HR Director) who also serves as a trustee. This person might be conflicted because they are aware of important information in their company role which impacts on their trustee decision making. They may also find it impossible to make decisions as a trustee given that they are also making decisions on the same matter but as a representative of the company. Other conflicts can occur when trustees are also members of the scheme and are required to make decisions about their own benefits which might also impact on other members or categories of members.

It is not possible to eradicate conflicts altogether and instead the trustees must have determined a formal approach for managing these situations. The regulator requires that trustees have a written conflicts policy and keep this regularly under review. They should also appropriately document the position relating to conflicts in the minutes of trustee meetings and should take legal advice where necessary. The written policy will set out what steps need to be taken if a trustee is conflicted in a particular circumstance.

Trustees are required to keep a register detailing the financial interests and other appointments of each trustee so that this can be referred to where necessary. They will also need to have regard to any potential conflicts which may be experienced by their advisers and should ask them to disclose and document the relevant details.

2.5.6 Risk Management

Trustees have to establish and operate internal controls which are adequate for the purpose of securing that their scheme is administered and managed in accordance with the scheme Trust Deed and Rules, the requirements of the law and the Code of Practice.

The regulator has suggested that trustees adopt a risk management approach which involves the preparation and maintenance of a risk register. In its regulatory guidance on internal controls, the regulator has set out the various steps in a typical risk management process and this is reproduced below:

Set objectives

When undertaking a risk management review, trustees should have a clear understanding of what the process is aiming to achieve.

Identify Risks

Trustees will need to consider all the key operations of their scheme and identify actual or potential risks which could be detrimental to their performance. The regulator expects trustees to use a formal risk register.

Define Success Criteria

Trustees need to take a proportionate approach to managing risk and recognise that risk cannot be completely eliminated. Trustees need to consider to what extent risks can be absorbed by the scheme and which risks they must manage.

Assess Risk

Trustees need to evaluate each risk identified and categorise it depending on its impact (e.g., financial) and likelihood of occurrence.

Produce Action Plan

After evaluating the different classes and categories of risk, trustees need to decide on the best approach for managing (or controlling) these. This will include identifying responsibilities and time scales for delivering internal controls. Whilst this could be recorded in an action plan, the risk register could also capture this information.

Implement Action Plan

Trustees need to ensure that performance against the action plan is monitored and those responsible for certain activities deliver within agreed timescales.

Monitor and Review

The design and implementation of an internal controls' framework is not a one-off exercise. Trustees need to continually monitor the effectiveness of controls to ensure they are still adequate, and periodically review their scheme's exposure to new and emerging risks.

Following the guidance on IRM, it will be necessary for trustees to review their approach to risk management with particular reference to funding. It is worth noting, however, that many schemes already have an IRM approach in place or are part way to achieving this and that the existing approach to internal controls will form a part of this process. More detailed comments on IRM are covered in Part 4, Chapter 3.3.

2.5.7 Appointment of Advisers and Other Providers

The trustees will need to obtain expert advice, where appropriate, on matters such as investment management, funding, covenant assessment etc. For a DB scheme, it is expected that the trustees will need to appoint the following:

- a Scheme Actuary to provide advice on the statutory funding requirements and other matters of an actuarial nature
- a scheme administrator to manage the scheme's membership records and to calculate and pay member benefits
- a legal adviser
- an investment manager or managers and an investment adviser
- a covenant adviser
- an auditor
- The regulator has issued guidance on trustee relationships with advisers and service providers that covers the following aspects:
- Appointment – trustees should have an appointment process in place and should ensure that the person or organisation involved has the appropriate level of skill and knowledge and are suitable for the role
- Contractual terms – a contract should be agreed which sets out the terms under which the adviser or service provider is appointed and their fee basis. It should also set out any notice period and exit fees and make it clear who would pay to correct any errors. In the event of the contract being terminated, it should provide for information being released back to the trustees within a reasonable timescale
- Conflicts of interest – the trustees should establish how each adviser or service provider manages conflicts of interest and the specific processes which they have in place to achieve this
- Managing ongoing relations – the trustees should have controls in place to ensure they maintain an effective working relationship with all their advisers and service providers and should regularly evaluate their performance and service
- Review – if as part of the monitoring approach it is decided to change a particular adviser or service provider, the trustees should consider the associated costs and any impact which there might be on members. They should also identify any risks or practical difficulties associated with the change before going ahead.

A review process can take a number of forms from an informal discussion amongst the trustees to a structured formal review by a third party or a beauty parade where the sitting adviser is asked to compete with other firms for the trustees' business

2.5.8 Providing Information to Members

The trustees must make certain information available to members, prospective members and other individuals as required taking into account the disclosure of information requirements. They should also have a defined process in place for resolving disputes with members. The quality and accuracy of the trustees' communications will be important in terms of member outcomes and so it is important that the information provided is clear and understandable.

2.5.9 Record Keeping

Robust record keeping with appropriate internal controls is a fundamental requirement for trustees to ensure that the scheme data is up to date, complete and accurate. The employer will also need to provide accurate and timely information (for example, as part of annual renewals).

The regulator has issued guidance on record keeping and introduced specific record keeping requirements in 2010 which schemes need to adhere to (see Part 2, Chapter 1.3).

2.5.10 Arrangements in Respect of Contributions

The trustees must have established processes in place to produce and maintain a schedule of contributions and to check that contributions are paid in accordance with the schedule. They should also contact the employer promptly to alert them about a payment failure and to try and resolve it with any material late payments being reported to the regulator. See Part 2, Chapter 2.1.1 for further information.

2.5.11 Funding and Investment Arrangements

Established processes to manage the funding and investment of the scheme are also needed and are covered in Part 4 of this study manual.

2.5.12 Arrangements relating to Additional Voluntary Contributions (AVCs)

The trustees are responsible for managing any AVC arrangements which are in place under a scheme and in many cases, this gives rise to separate considerations as AVCs are typically provided on a DC rather than a DB basis.

Part 2, Chapters 2.2 and 2.3 provide some more detailed background and comments on the administrative aspects of managing an AVC arrangement. The trustees are also responsible for the investment of the AVCs and the communication of information to members. The various pension flexibilities which came into effect from 6 April 2015 have increased the issues which need to be considered by trustees in these areas. The regulator's Code of Practice 13 (Governance and administration of occupational trust-based schemes providing money purchase benefits) applies in certain areas to AVCs and a new version came into force in July 2016. In preparing the Code, the regulator has recognised that some legal obligations which apply to DC schemes in general do not apply to AVC arrangements under DB schemes. It has also been confirmed that where the requirements do apply, trustees are able to adopt a proportionate approach to meeting the relevant standards of the Code. Trustees should consider what this means in practice and should ensure that appropriate monitoring processes are in place in respect of the AVC arrangements which they are responsible for.

Summary

DB pension schemes are usually established under trust. The governance arrangements for such pension schemes have their origins in ancient trust law and the Trust Deed will detail the powers and responsibilities of both the trustees and the sponsoring employer.

Trustees have a number of key duties and powers, such as the need to act impartially and in the best interests of members. Over time changes introduced by legislation, in particular the Pensions Act 1995 and Pensions Act 2004, have extended the legal duties and responsibilities of trustees.

The wide range of material which has been produced by the Pensions Regulator, including Codes of Practice and other regulatory guidance, has led trustees to review and improve the governance of schemes.

When considering what is good governance and best practice, trustees have to take a number of factors into account, such as the trustees' level of knowledge and training, managing trustee meetings and the decisions trustees have to make and avoiding conflicts of interest.

Trustees must appoint a number of advisers to assist them in their duties and regularly review the performance of those advisers.

Self Test Questions

- Explain the duties which the trustees have to the beneficiaries of a trust.
- Describe the role and objectives of the Pensions Regulator and how this has impacted on the governance arrangements for pension schemes.
- Explain how and why the trustees of a pension scheme would use a risk register.
- Explain three elements of best practice for trustees when managing a pension scheme.

Part 4

SCHEME FUNDING AND INVESTMENT STRATEGY

OVERVIEW

As explained in Part 1, the security of members' benefits in a DB scheme relies on the scheme being adequately funded. This Part examines the principles of funding retirement benefits and how the level of contribution is calculated. We will also consider some of the legal and regulatory framework relating to funding registered pension schemes.

Understanding the principles of scheme funding is vital to fully appreciate how DB schemes operate and the challenges that employers and trustees face in maintaining DB provision.

Chapter 1 looks at the actuarial principles and methods used to calculate the appropriate contribution rate for a scheme. This includes the funding basis and the various assumptions that underpin the calculations.

In Chapter 2 we look at the requirements for actuarial valuations and in Chapter 3 we move on to consider the Statutory Funding Objective, which is the funding regime introduced under the Pensions Act 2004.

Chapter 4 looks at the requirement for the funding position of a scheme to be reflected in a company's accounts, whilst Chapter 5 addresses the issues surrounding the setting of actuarial factors that are used in the calculation of members' benefits.

Chapter 6 looks at the factors and requirements trustees should consider when setting an appropriate investment strategy for a scheme to ensure that a scheme's assets are sufficient to cover its pension liabilities.

This Part builds on the issues considered in earlier Parts. For example, scheme design (Part 1) and member data and benefits (Part 2) dictate the cost and provide the data for the actuarial valuation, which also takes into account the value of the scheme's assets.

After studying this Part, you should understand how pension scheme liabilities are calculated, how the contribution rate is determined, how a scheme's funding position is reflected in the sponsoring company's accounts, how actuarial factors are applied to calculate the value of benefits and the considerations that are taken into account when setting the investment strategy for the scheme.

CHAPTER 1

Actuarial Principles And Methods

INTRODUCTION

Funding involves setting money aside in advance to pay for the benefits promised by the pension scheme. For a DB scheme, a method needs to be chosen in order to put a value on the benefits to determine the size of fund required. This chapter looks at the most common funding methods. Funding calculations are based on estimates of future contribution income and benefit expenditure, using the principle of discounted cash flow. To make these estimates the scheme actuary makes assumptions about a range of factors such as future salary growth, future investment performance, scheme members' life expectancy and so on. This chapter also examines the types of assumptions the actuary makes and explains the discounted cash flow principle.

An understanding of how the scheme's contribution rate is calculated and of the underlying assumptions is important in appreciating how the scheme can achieve security and stability as well as meeting its legal obligations.

After studying this chapter, you should understand the two most common funding methods and the assumptions that go towards determining a scheme's contribution rate.

1.1 CHOICE OF FUNDING METHOD

The first stage in selecting a funding method is to decide what the funding objective is. For an occupational pension scheme this decision will usually be made following discussions between the sponsoring company, the scheme trustees and the actuary. The funding objective could, for example, be:

'To build up and then maintain a fund which will be sufficient to meet all liabilities relating to pensionable service completed to date, allowing for future salary increases for active members of the scheme.'

The trustees will then choose a funding method which aims to achieve the objective. If more than one funding method is suitable the actuary may discuss the various options with the trustees and the sponsoring company. The funding method will then dictate the level of contribution needed to fund the benefits.

The Occupational Pension Schemes (Scheme Funding) Regulations 2005/3377 require the trustees to be involved in determining the funding objective and the contribution rate, however depending on the scheme rules, these may require agreement from the employer and/or the actuary.

In this chapter, the following funding methods, which are the most commonly used, are described in detail:

- Projected Unit
- Attained Age

1.1.1 Standard Terms

There are some standard terms used which are defined as follows:

Target Fund

This is the fund which would need to exist at a valuation date (the date as at which the scheme's funding position is assessed) if the objective of the funding method was met as at that date. If the value of the scheme's assets at the valuation date exceeds the Target Fund the scheme is said to be in surplus. If the opposite applies the scheme is said to be in deficit.

Standard Contribution Rate

This is the rate of contribution required to fund the future benefits which would apply under a particular funding method if the scheme's assets at the valuation date were equal to the Target Fund. It is usually expressed as a percentage of scheme members' pensionable earnings.

Projected Earnings

Earnings of active members projected forward in line with assumed salary growth to the members' expected dates of retirement or leaving service.

Past Service Liabilities

The liabilities of the scheme based on pensionable service up to the valuation date. These include liabilities for pensions in payment, benefits contingently payable to spouses and dependants on a pensioner's death,

preserved benefits for members whose pensionable service has ceased and accrued benefits for members still in pensionable service. For active members, the calculation of liabilities may be based on Projected Earnings.

Modified Contribution Rate

The Standard Contribution Rate modified to eliminate any difference between the Target Fund and the value of the scheme's assets at the valuation date.

1.1.2 The Projected Unit Method

Description

A value is placed on the benefits expected to accrue over the next year to scheme members at the valuation date, allowing for Projected Earnings.

The Standard Contribution Rate is this figure divided by the value of total pensionable earnings for scheme members over the next year.

The Target Fund is equal to the Past Service Liabilities, allowing for Projected Earnings for active members.

The Modified Contribution Rate is the Standard Contribution Rate adjusted to eliminate any difference between the Target Fund and the asset value over a specified period. The period will be chosen following discussions with the scheme trustees and the sponsoring company. For example, the average future lifetime of the active membership may be chosen.

Characteristics

The Standard Contribution Rate is the rate needed to finance the benefits expected to be earned over the year following the valuation date, based on Projected Earnings. It will remain stable if the age, sex and earnings distribution of the membership remain reasonably constant. This stability is only possible where there will be a continuing flow of new members to replace those who leave or retire.

The Projected Unit method was, until recently, the most commonly used funding method. However, it is most suited to funding schemes which are open to new entrants. If it is applied to a closed scheme, it produces a contribution rate which rises steadily as the membership ages. (In a closed scheme, the average age of the membership increases over time.)

For some purposes, legislation requires that the Projected Unit method is used and it must be used under all the major accounting standards, as these are concerned with the cost of benefits as they are earned each year. (See Part 4, Chapter 4 for details of accounting standards.)

1.1.3 The Attained Age Method

Description

A value is placed on the benefits expected to accrue for all expected future service of the scheme membership at the valuation date, allowing for Projected Earnings.

The Standard Contribution Rate is this figure divided by the value of total pensionable earnings for the scheme membership throughout their expected future membership.

The Target Fund is equal to the Past Service Liabilities, allowing for Projected Earnings for active members.

The Modified Contribution Rate is the Standard Contribution Rate adjusted to eliminate any difference between the Target Fund and the asset value over a specified period - say five or ten years. Again, the period will be agreed between the scheme trustees and the sponsoring company but would usually be a shorter period than under the Projected Unit method.

Characteristics

The Standard Contribution Rate under the Attained Age method is effectively the average contribution rate required to fund the benefits over the period of future pensionable service of the scheme membership at the valuation date. It does not assume that there will be any future new entrants to the scheme. As such it generally produces a higher rate than the Projected Unit method.

This method is becoming increasingly appropriate and common for the funding of DB pension schemes, as more and more schemes are closed to new entrants.

Initially, Standard Contribution Rates derived under the Attained Age method tend to be more than required to finance the next year's benefit accrual. However, within a closed scheme the membership will age, and the contribution required to finance each year's benefit accrual will increase over time. The higher contribution rates paid in the earlier years should produce a surplus so that the scheme can adopt a lower Modified Contribution Rate in later years. Overall, within a closed scheme, this method will mean the contribution rate required from valuation to valuation should remain more stable.

Example 1: Use of the Attained Age and Projected Unit Methods

The Colourboxx Final Salary Plan (CFSP) and the Colourboxx Cosmetics Retirement Benefits Scheme (CCRBS) are both likely to be valued using two different methods:

- for calculating the ongoing funding position during the three yearly actuarial valuations, the Attained Age method is likely to be used as the CFSP is open by invitation only so is unlikely to have a stream of new entrants and the CCRBS is closed to new entrants
- for calculating the figures for the Company Annual Report and Accounts the Projected Unitmethod will be used as this is required by the Financial Reporting Council

1.1.4 Schemes Where Defined Benefits Have Ceased to Accrue

In these schemes there are no future benefits to consider. Thus there is no Standard Contribution Rate and the Target Fund is equal to the Past Service Liabilities. No allowance for Projected Earnings is required unless a link to final salary is retained for past service even though no further pensionable service accrues.

The contribution rate will be the amount required to eliminate any difference between the Target Fund and the asset value over a specified period - for example the average period to retirement of the deferred pensioners.

1.2 ACTUARIAL ASSUMPTIONS

These fall into two groups:

FINANCIAL ASSUMPTIONS - THE RATE OF:	DEMOGRAPHIC ASSUMPTIONS - THE RATE OF:
Price inflation	Withdrawal from service
General salary growth*	Death in service
Pension increases	Early retirement
Future return on investments	Individual salary progression relative to the general increase*
	Mortality in retirement

* *Unless benefits have ceased to accrue and the scheme has not maintained a link to final salary for benefits already accrued.*

1.2.1 Financial Assumptions

Financial assumptions generally have a greater impact on the results of actuarial calculations than demographic assumptions, although the assumed rate of mortality in retirement can also have a large impact on liabilities. When advising on assumptions the actuary will look at past financial statistics and review them in the light of current conditions, taking into account views on future prospects expressed by economists, other commentators and other actuaries.

Pension liabilities have a very long-time frame - today's young pension scheme member may still be receiving a pension from the scheme in 60-80 years' time. Therefore, the financial assumptions adopted represent long term average rates applicable to the next 20-30 years. This can sometimes be a source of confusion for scheme members and also for trustees, as the long-term assumption for salary growth or inflation, for example, can be different from the current rate of salary growth or inflation.

The main assumptions, and the traditional methods of selecting them, are described below.

Price Inflation

Price inflation is often the pivot around which the other financial assumptions are fixed. The other assumptions, such as salary growth, may be expressed in 'real' terms, i.e., relative to the rate of inflation. As inflation is perhaps the most widely discussed and measured economic indicator, it is relatively easy for the actuary to form a view on future inflation, although it is difficult to make long term forecasts with any degree of precision.

Fortunately, it is not essential for the actuary to predict the future long term inflation rate accurately. It is more important to quantify the relationship between inflation and the other assumptions reasonably correctly, as it is the differences between the financial assumptions rather than their absolute values that have the greatest effect on the calculated results.

The rate of price inflation can broadly be determined from the difference between yields on fixed interest and index linked stocks at the valuation date. This is the average rate of future inflation that the market is anticipating.

Example 2 - Market Implied Inflation

At the valuation date:

- the yield on Government fixed interest stocks is 3.25% per annum
- the yield on Government index linked stocks is 0.25% per annum

The rate of inflation implied by the market is 3% per annum i.e. (1.0325/1.0025 -1) / 100

General Salary Growth

Over the long term, average earnings in the UK tend to increase faster than price inflation. Therefore, most valuations would assume salary growth between price inflation and price inflation plus 1.0%. The choice of assumption might be influenced by the nature of the industry concerned; for example, pay increases are likely to be greater in growing sectors of the economy than in declining sectors. If the scheme has been closed and therefore now only covers a limited group of employees this may also impact on the salary growth assumption and in some such schemes, pensionable salary increase rates are limited to a maximum amount.

Example 3 - Real and Absolute Assumptions

If average long term future price inflation has been set at 3% per annum, and real salary growth is assumed to be 1% per annum, salary growth in absolute terms is approximately 4% per annum.

Pension Increases

The allowance made for pension increases depends on the benefit structure of the scheme. Different levels of increase are considered below.

- **Index linked pensions:** Provision would be made for increases in line with the assumed rate of price inflation.
- Pension with no guaranteed increases, or guaranteed increases at a fixed rate. Allowance would be made for any guaranteed rate of increase.
- **Pension with discretionary increases:** Some allowance might be made for discretionary increases over and above any guaranteed level. This would depend on whether a practice of granting discretionary increases had been established. The sponsoring employer and the trustees could have some input on this assumption. Some employers may want to fund for discretionary increases in advance, others may not.
- **Limited Price Indexation (LPI):** Pensions subject to LPI increase annually in line with inflation, subject to a fixed limit. This method is often used for calculating statutory minimum pension increases. From 1 January 2011, statutory minimum increases to pensions in payment are based on increases in the Consumer Prices Index (CPI) for the 12 months ending the preceding September. Before 2011, statutory minimum increases on pensions relating to these periods of service were based on the increase in the Retail Prices Index (RPI).

Currently, CPI with a maximum of 5% (5% LPI) must be provided on pension relating to service between 6 April 1997 and 5 April 2005, CPI with a maximum of 2.5% (2.5% LPI) must be provided on pension relating to service from 6 April 2005 and CPI with a maximum of 3% (3% LPI) must be applied to post 5 April 1988 Guaranteed Minimum Pensions (GMPs).

The above are the statutory minimum pension increase requirements and some schemes may continue to use RPI as the increase basis and/or apply a different reference period, depending on their rules. Schemes that continue to use RPI as the increase basis or use a different reference period are exempt from the statutory requirements. (See Part 2, Chapter 3.1.8 for more information on pension increases.)

The treatment of LPI depends on the assumption for future inflation. In a low inflation environment, the LPI rate of increase will be close or equal to the assumed inflation rate. In a high inflation environment, it will be close to the fixed limit.

Example 4 - Pension Increase Assumptions

The average rate of future inflation is assumed to be 3% per annum.

In this scenario the 2.5% limit is assumed to bite (i.e., the cap is to have effect) virtually every year but the 5% limit is not expected to bite. The 2.5% LPI increase assumption would be set at or just below 2.5% and the 5% LPI increase assumption would be set at around 3%.

Future Return on Investments

This is perhaps the most difficult assumption to set. The starting point is generally the 'least risk rate', which is the rate of return available on the least risk assets that most closely match the scheme's liabilities. The least risk assets are normally taken as UK Government fixed interest or index linked bonds.

In practice most pension schemes invest a portion of their fund in riskier assets, such as equities, in the expectation of higher returns. The assumed return on future assets is therefore often taken as the least risk rate plus an allowance for the expected extra return on these riskier assets. There is, however, no consensus on how to determine the expected extra return, or how much weight to place on the scheme's current investment policy. It is left to the actuary to advise the trustees as to the possible approaches.

Different assumptions are often set for the return on investments when valuing benefits before and after retirement. This is because, as the proportion of pensioners increases, the trustees may wish to invest less in equities and more in gilts and bonds as these are a better 'match' to pensioner liabilities. Gilts and bonds are lower risk investments and provide a more stable return for the scheme, which is more appropriate when the scheme has to pay out a large amount of regular pension instalments.

So, the pre-retirement investment return, relevant for members not yet retired, may assume that a significant proportion of the underlying assets are invested in equities. The post-retirement investment return, which applies for pensioners and current active and deferred members once they reach retirement, may anticipate that the underlying assets are largely gilts and bonds.

Advances in valuation systems are also allowing trustees to consider more sophisticated approaches to setting assumptions about the returns expected on the scheme's investments. Rather than a separate pre- and post- retirement return, the trustees may wish to specify a term-dependent rate of return which reflects for each member the length of time to retirement.

Accounting standards also have requirements regarding the setting of the investment return assumption. Often these will be based on high quality corporate bond yields.

Example 5 - Calculating Investment Yield Assumptions from Gilt Yields

Index linked gilts yield 0.25% at the valuation date Assumed long term rate of inflation is 3% per annum

The actuary decides that the classes of investment held by the scheme should yield 1% more than index linked gilts

The future return on pre-retirement investments is therefore set at 3% + 0.25% + 1% = 4.25%

1.2.2 Demographic Assumptions

A valuation of a very large pension scheme usually includes an analysis of the scheme membership over

a recent period, such as the three years preceding the valuation date. The results of the analysis are used to decide the demographic assumptions adopted for the valuation. For the vast majority of schemes, the results will not be statistically significant, and the demographic assumptions may be based on those appropriate to larger schemes operating in similar areas of employment or the general population.

The main demographic assumptions are described below.

Withdrawals

In schemes that remain open to future accrual, an assumption will be made as to how many current active members will leave the scheme before retirement. At one time the withdrawal of scheme members was a source of 'profit' to a pension scheme because the value of deferred benefits was much less than the value of the salary related benefits the members would have received had they remained in service. Consequently, only a modest level of withdrawal was often assumed as a prudent measure. Statutory revaluation of deferred pensions means that the difference in benefit values is now much less significant (and even less so in CARE schemes that revalue earnings for deferred members in the same way as for active members) and more realistic withdrawal rates are used.

Rates of withdrawal from year to year are difficult to predict as they depend on economic and social conditions, and on employment conditions in the company concerned.

Death In Service

Most schemes provide a benefit on death before retirement while in pensionable service. Typically, this includes a lump sum of a multiple of salary together with dependants' pensions. An assumption must be made as to the rate of mortality expected before retirement. Schemes often insure death in service benefits, particularly the lump sum element, in which case it is the insurance premium cost that is usually taken into account and the assumption is not required.

Early Retirement

Early retirement may be ignored if it takes place on actuarially neutral terms. If terms are not neutral some allowance for early retirements should be made, and variations in that allowance can have a material effect on the results.

Ill Health Early Retirement

Many schemes provide generous benefits on ill health early retirement, and a larger than expected number of such retirements can therefore put a financial strain on a scheme. Numbers of ill health retirements depend on the nature of the industry in which scheme members are employed and will also be influenced by the attitude of the sponsoring employer towards such retirements and the provisions of the scheme rules.

Some schemes assume that life expectancy is much reduced after retirement due to ill health by adjusting the mortality in retirement assumption (see below).

Earnings Progression

As well as general earnings increases, an allowance is made for increases given to individuals as a result of increased responsibility and experience. For larger schemes earnings scales varying according to age and sex may be adopted, based on the scheme's own experience. For smaller schemes a flat rate addition to the general rate of salary growth is often made to cover individual progression.

Mortality in Retirement

This is often the most financially significant of the demographic assumptions. The assumption is usually based on standard tables produced using the mortality experience of insurers, pension schemes or from general population statistics. These tables may be adjusted to reflect the membership, for example by considering their occupation or where they live (postcode analysis).

Recent improvements in life expectancy have led to many schemes strengthening the assumptions used, to take account of both past improvements and a projected level of future improvements. There is much debate about the extent to which these improvements will continue into the future, however it is prudent to include some allowance for increases in life expectancy to continue for both existing and future pensioners.

1.2.3 The Overall Picture

The entire package of assumptions is known as the valuation basis. Each assumption forming a part of the basis may be chosen from a range of possible values. There is no one 'correct' basis and different bases may be adopted for different purposes. For example, for accounting purposes the sponsoring company may adopt a 'realistic' basis, where each element represents the actuary's best estimate for a particular assumption. For funding purposes, the trustees and employer generally adopt a 'prudent' basis, where there are margins in some of the assumptions that aim to cushion the fund against adverse experience.

There is no prescribed set of actuarial assumptions which must be used in a valuation for the purposes of the Statutory Funding Objective, although they must be chosen 'prudently' by the trustees. The trustees must seek actuarial advice in choosing assumptions and, depending on the scheme rules, may need to reach formal agreement with the employer concerning the assumptions used, or explain to the Pensions Regulator why they have been unable to reach an agreement.

1.2.4 Valuing the Scheme's Assets

A scheme can hold a wide variety of investments including equities, bonds, cash, property and derivatives. These are valued on an annual basis and the values reported in the Trustees' Report and Accounts. For these assets, the value from the audited accounts must be used for the purposes of a valuation.

Similarly, if a scheme has some DC assets and liabilities (such as member AVCs) they are taken as the market value from the accounts.

An exception to this is if the trustees have carried out a buy in (see Part 4, Chapter 6.8.3) with an insurance company for some members and hold policies in respect of those members. As these are also an investment of the scheme they need to be valued, which is not as straightforward as taking a value from the accounts. It is up to the scheme actuary to place a value on this asset using assumptions that are consistent with those that are used to value the liabilities.

1.2.5 Contingent Assets

A contingent asset is an asset on which the pension scheme would have a claim if one or more specified future events occurs. By their nature they do not represent an actual direct injection of cash into a scheme unless the contingent event occurs; in other circumstances they are not available to the trustees.

The use of contingent assets has become increasingly common in the context of pension scheme funding. The most common types of contingent asset which tend to be used include:

- escrow accounts - these are similar to a normal bank account, but they are set up on terms which provide that all (or a specified amount) of the money which is paid into the account will be paid to the trustees of the pension scheme on the occurrence of specified trigger events (such as the insolvency of the principal employer), and otherwise the funds will be returned to the employer
- charges over property or other assets
- letters of credit - these are usually issued by a bank in return for a premium paid by the employer. Monies would typically only be payable under a letter of credit on the occurrence of certain specified events, such as the insolvency of the principal employer
- group company guarantees

For trustees, contingent assets can offer support to the strength of the employer covenant (see Part 4, Chapter 3.3) and an increase in scheme security should future experience prove adverse.

There are a number of reasons why employers might choose to put in place a contingent asset in respect of their scheme including:

- it can be offered as an alternative to direct cash funding
- contingent assets can be used to support trustees' agreement to:
  - maintain or increase the risk in the investment strategy
  - adopt less conservative assumptions in setting a scheme's 'technical provisions' (see Part 4, Chapter 3) and/or accept a longer recovery period

Some employers have also been concerned that their schemes might end up back in surplus and they see contingent assets as a way of avoiding large sums of money becoming locked up in their scheme (as it is difficult for employers to receive a refund of surplus from their pension scheme).

Trustees should ensure they fully understand the value and terms associated with a contingent asset and assess the appropriateness of a particular contingent asset in the context of their scheme.

The use of some contingent assets may also lead to a reduction in a scheme's Pension Protection Fund (PPF) levy (see Part 5, Chapter 2.6.2).

1.3 ACTUARIAL PRINCIPLES

1.3.1 Discounted Cash Flows

Actuarial values are based on the concepts of discounted cash flows and present values. They are based on the premise that £1,000 payable in a year's time is less valuable than £1,000 payable today, because an additional one year's interest will be earned on the money payable today compared to that due in a year's time.

Example 6 - Discounted Cash Flow

Suppose it is possible to earn interest of 10% per annum

The sum that you would need to invest today in order to provide £1,000 in a year's time is £909.10.

This is because £909.10 X 110% = £1,000

So, in this example, the present value of £1,000 payable in a year's time is £909.10

1.3.2 Projection of Expected Cash Flows

Benefit Outgo

Future payments from a pension scheme will relate to a variety of benefits - pensions in payment, pension commencement lump sums at retirement, payments on death in service, refunds of contributions and so on. Expected future cash flows are derived based on the assumptions described in Part 4, Chapter 1.2.

Each cash flow is multiplied by its likelihood of being paid and discounted using the relevant assumed rate of investment return, to obtain its present value at the valuation date. All the discounted cash flows are then added together to arrive at a single figure for the present value of benefit outgo from the scheme.

The present value of benefits is usually split into the value of 'past service' benefits - those relating to pensionable service up to the valuation date, and 'future service' benefits - those relating to service expected to be completed after the valuation date.

Contribution Income

Typically, the value of a contribution of 1% of scheme members' future pensionable salaries is calculated, again by estimating future streams of income and discounting them to the valuation date. This figure is then used to calculate the value of future members' contributions, if payable, and the value of the employer's contributions.

1.3.3 Results

These calculations form the raw materials which are then used to assess the financial position of the scheme and to calculate the level of funding required for the scheme.

Summary

This chapter has described the common methods for scheme funding and the assumptions that form the valuation basis.

The first stage in selecting a funding method is to decide on what the scheme's funding objective will be, so that the actuary can advise the trustees on a funding method that aims to achieve that objective.

The most commonly used funding methods are the Projected Unit method and the Attained Age method. The central difference between the two is that the Projected Unit method considers the value of the benefits that are expected to accrue in the next year, whilst the Attained Age method looks at the value of the benefits that are expected to accrue across the entire future service of the scheme members.

The Projected Unit method is more appropriate to schemes that are open to new entrants, whilst the Attained Age method is more suitable for closed schemes.

As well as selecting the funding method, the trustees must adopt a number of financial and demographic assumptions, after obtaining advice from the actuary. The financial assumptions, which include such factors as future price inflation and future investment returns, usually have a larger impact on the final results than the demographic assumptions such as the rate at which members will leave the scheme, although the mortality in retirement assumption can also have a significant impact.

The overall set of assumptions adopted by the trustees is the valuation basis. Although there is no prescribed valuation basis for the Statutory Funding Objective, the assumptions used must be chosen prudently.

Funding calculations are based on the principle of discounted cash flow. The underlying principle is that £1 payable now is worth more than £1 payable in ten years' time, or put another way, that in order to have £1 in ten years' time a lower amount would need to be invested now. Future streams of benefit outgo and contribution income are projected and then discounted back to the present date and added together to calculate the value of the liabilities of the scheme.

Self Test Questions

- Describe the differences between the Projected Unit and Attained Age methods and explain why the Attained Age method is becoming more common.
- Distinguish between the Standard Contribution Rate and the Modified Contribution Rate.
- Describe the part played by returns on index linked gilts in setting the assumed rate of future investment return.
- Explain why the assumption for future salary growth used in funding calculations might be very different from the current rate of salary increases for scheme members.
- Explain how the assumption about future inflation impacts on the assumed rate of pension increases where the pensions are subject to LPI.
- Describe three demographic assumptions that could be applied in a valuation and explain why they are relevant.

CHAPTER 2

Actuarial Valuations

INTRODUCTION

In this chapter, we will look at the contents of the actuarial valuation and the factors that may influence the recommended rate of future contributions. We will also look at the 'discontinuance position' and the order in which benefits must be secured if an underfunded scheme winds up.

An understanding of the content of an actuarial valuation report is important because all funded DB schemes (including hybrid and CARE schemes) must have a full valuation at least once every three years and the report must contain certain prescribed information. Under the Occupational Pension Schemes (Scheme Funding) Regulations 2005/3377, annual actuarial reports must also be produced between valuations, updating the results of the full valuation.

The main purposes of an actuarial valuation are:

- to assess the funding level of a pension scheme, and
- to provide advice on the level of contributions which should be paid in future

To do this, the benefits are valued using one of the methods described in Part 4, Chapter 1 and an appropriate set of assumptions.

After studying this chapter, you should understand the content of an actuarial valuation report, the issues to consider in setting the contribution rate, the significance of the discontinuance position and the priority order for securing benefits, which is particularly important if a scheme winds up whilst underfunded.

2.1 THE VALUATION REPORT

The actuary must prepare a formal report, known as the Scheme Funding Report, on the valuation. For valuations under the Statutory Funding Objective, the report must generally be produced within 15 months of the effective date of the valuation. The report must be made available to scheme members on request.

The report should be written in such a way that an informed reader can understand the financial position of the scheme, including how it has changed since the last valuation and how it might change in future.

The report must show:

- the results of the valuation, including the current funding levels on the technical provisions basis, the funding level on the assumption that the scheme wound up on the valuation date, the future service cost and, if agreed, details of future contributions
- a summary of the data on which the report is based, including the scheme's funding objective, the methodology and the assumptions, summaries of the membership data used, and the benefits valued, and information about the scheme's assets
- the development of the scheme since the last valuation, including analysis of any change in funding level split across the causes contributing to that change, any changes in membership or benefits, and details of any contributions paid in that time
- a description of the risks to the financial position of the scheme, including any mitigating actions that the trustees have taken and how sensitive the results of the valuation are to changes in the key assumptions
- the position if the scheme was forced to wind up, including the effect on members' benefits and an analysis of the difference between current funding levels on a technical provisions' basis and the funding level assuming that the scheme wound up
- projections of what the funding levels could be at the next valuation, based on the future contribution rate, if agreed

The FRC has recently revised the TAS framework and a new TAS, TAS300: Pensions, came into effect on 1 July 2017. However, the requirements for valuation reports will remain broadly similar to those under the Pensions TAS.

2.2 RECOMMENDED CONTRIBUTION LEVEL

If the scheme is continuing to provide salary related benefits to active members on an ongoing basis, the contribution rate required to fund the benefits expected to accrue in the future will first be determined.

The overall level of contribution recommended in the report will depend on the treatment of any deficit or surplus revealed by the valuation. The period over which the deficit (or surplus) is to be removed will be decided after discussions with the trustees and the sponsoring employer.

If the scheme is in deficit the contribution rate will depend upon:

- the extent of the sponsoring employer's legal obligation and financial ability to support the scheme now and in the future
- the size of the deficit in absolute terms and relative to the size of the employer
- whether the sponsoring employer is likely to become insolvent in the near future
- any conditions imposed on employers' contributions by the scheme's Trust Deed and Rules
- the Pensions Regulator's Code of Practice on funding defined benefits. This gives guidance to trustees on recovery periods and is discussed in Part 4, Chapter 3
- for the employer, considerations relating to accounting standards FRS 100, 101, 102 or IAS 19R (see Part 4, Chapter 4)
- whether there are any other sources of funds in the event of the employer becoming insolvent, such as guarantees from other companies

If there is a surplus it may be removed by reducing the employer's (and possibly members') contribution rate, depending on any scheme rules relating to how a surplus might be removed. Alternatively, some or all of the surplus may be left in the scheme. A surplus may also be used to improve scheme members' benefits, but this is now less common as employers generally seek to reduce their liabilities rather than to add to them. In some cases, where the scheme rules allow, the employer may seek a refund of surplus from the scheme, but these receive quite penal tax treatment and can only be made in certain circumstances.

2.3 DISCONTINUANCE POSITION

The actuary must assess what the effect on members' benefits would have been had the scheme discontinued on the valuation date, i.e., if pensionable service ceased and the employer made no further contributions to the scheme. Normally in this event any active members of the scheme would become entitled to deferred pensions (or immediate pensions, if over normal pension age).

A scheme which discontinues may either be continued as a closed scheme, or it may be wound up and the liabilities extinguished by the payment of transfer values and/or the purchase of annuities. The approach taken depends on the provisions in the rules and, to some extent, the size of the scheme. A large scheme might be left to run on, but a smaller scheme would usually be wound up.

For a scheme likely to wind up on discontinuance, the assessment of pensioners' liabilities would be based on the cost of buying immediate annuities. For deferred (and active) members the liabilities would be based on the cost of buying deferred annuities. Allowance would be made for the expenses of winding up. The scheme's assets would be taken into account at market value.

As annuities can be expensive, deferred annuities particularly so, it is quite likely that a scheme which is adequately funded under an ongoing funding method may be insolvent on discontinuance. The discontinuance position will vary with market conditions, so the assessment at the valuation date is a snapshot.

The valuation report will state which part of the scheme's liabilities would be covered on discontinuance and which would not. There is a statutory priority order for allocating resources when a DB scheme is wound up. This priority order effectively dictates which benefits will and will not be secured when an underfunded scheme winds up. The current winding up priority order, introduced from 6 April 2005, aims to ensure that the order of benefits provided ties in with the Pension Protection Fund (PPF) and the benefits it will provide (see Part 5, Chapter 2). It ranks liabilities as follows:

1. expenses
2. voluntary contributions not covered by the PPF (e.g., DC AVCs)
3. certain pensions in payment insured before April 1997
4. pensions and other accrued benefits up to PPF liability (including voluntary contributions covered by the PPF)
5. remaining AVCs not covered in (2), (3) or (4)
6. any remaining pensions or benefits

For benefits available from the PPF (the 'PPF liability' referred to above), members under normal pension age, whether retired or not, rank as non-pensioner members and are covered for 90% of their entitlement with a maximum capped at £37,314 pa (90% of £41,461 p.a). at age 65. (1 April 2020) Their remaining benefits fall under category 6 of the priority order. Increases to pensions in payment are restricted to Limited Price Indexation (LPI) to a maximum of 2.5% a year on benefits accrued after 5 April 1997 only.

Increases above this level also fall into category 6. Further details about the PPF are provided in Part 5.

Following the Court of Appeal's decision in the Hampshire Case, the cap is unlawful on the grounds of age discrimination. Pensioners effected by it will be compensated, and the cap will no longer apply to new PPF retirees. The majority of cases have been compensated.

Summary

This chapter has explained the requirements for actuarial valuations and the need for the actuary to assess the discontinuance position for a scheme.

All DB schemes must have a full actuarial valuation once every three years. The primary purpose of an actuarial valuation is to assess the current funding level of the scheme and to provide advice on the future rate of contributions.

The valuation report must contain a range of information, including details of the data on which the valuation was produced and a statement of the scheme's funding objective. The assumptions used, an explanation of any change in the funding level since the previous valuation and other information must also be included.

The report will recommend a future contribution rate, which will take into account any surplus or deficit in the scheme's funding position. Where the scheme is in deficit, the period over which that deficit will be removed depends on a number of factors, including the size of the deficit and consideration of the Pensions Regulator's Code of Practice.

A key aspect of the valuation report is the scheme's discontinuance position and whether or not

the scheme would have been able to fund all accrued benefits if it had wound up at the date

of the valuation. A scheme that is fully funded on an ongoing basis may not be fully funded on discontinuance. There is a statutory priority order for securing benefits when an underfunded scheme winds up, which is tied to the benefits available from the PPF.

Self Test Questions

- Describe the main areas that a valuation report must cover.
- Outline the options available for removing any surplus in a scheme's funding position.
- Explain what is meant by the 'discontinuance position' of an ongoing scheme.
- Explain why a scheme that is fully funded on an ongoing basis may be underfunded on discontinuance.
- Where a valuation reveals that a scheme is in deficit, outline the factors that will influence the contribution rate.
- Describe how the benefits available from the PPF are reflected in the winding up priority order.

CHAPTER 3

The Statutory Funding Objective

INTRODUCTION

The Pensions Act 2004 brought in a statutory funding regime – the Statutory Funding Objective (SFO) - for all valuations with an effective date of 22 September 2005 or later. The Pensions Act 2004 also saw the formation of the Pensions Regulator to, among other things, oversee the operation of the new funding regime. Broadly, the SFO requires schemes to have sufficient resources to meet their 'technical provisions'. Technical provisions are the value of members' benefits accrued to the valuation date.

The Pension Schemes Act 2021 imposes a new duty on trustees of DB schemes to determine and keep under review a funding and investment strategy. The strategy will have to specify the funding level which the trustees intend the scheme to have achieved and detail the investments the trustees intend the scheme to hold at specific dates. The trustees will set out this information in a written statement of strategy, part 2 of which will take the form of an implementation report. Employer agreement will be required to the trustees' funding and investment strategy (although any amendments to the implementation report will only require consultation with the employer). The scheme's technical provisions will need to be consistent with the trustees' funding and investment strategy.

The Pensions Regulator in March 2022 published a statement on the conflict in Ukraine. It explains that the Regulator expects trustees to be vigilant and talk to their advisers about any action they may need to take, depending on the scheme's investment, risk management or employer covenant exposures. It adds that trustees should take steps to consider any action trustees may need to take – including in relation to investments – to align with sanctions announced by the UK Government.

In this chapter we will look at the trustees' responsibilities under the statutory funding framework, the circumstances in which the regulator may intervene in the running of a scheme and the valuation required for the Pension Protection Fund (PPF).

After studying this chapter, you should understand the SFO framework, the circumstances in which the regulator may intervene, and the valuation required for the PPF.

3.1 TRUSTEES' RESPONSIBILITIES

While the principles of the statutory funding framework were contained in the Pensions Act 2004, the detail of how the framework operates and guidance to trustees on their duties was set out by the Pensions Regulator in its Code of Practice on 'Funding defined benefits',

The Code of Practice was revised in July 2014.This was partly as a result of an additional statutory objective for the regulator introduced by the Pensions Act 2014 which requires that the regulator carries out its duties in relation to scheme funding in a way that "minimises any adverse impact on the sustainable growth of a sponsoring employer".

The funding regime explicitly places significant responsibilities on the trustees. Trustees are required to take responsibility for choosing valuation assumptions and cannot simply accept the scheme actuary's recommendations.

Under the funding regime the trustees must:

- obtain a full valuation and Scheme Funding Report once every three years, with annual actuarial reports being produced between valuations
- prepare a Statement of Funding Principles, which describes the way in which the trustees will comply with the SFO
- prepare a Schedule of Contributions (SoC) and have it certified by the scheme actuary
- prepare a Recovery Plan where the SFO is not met
- when a Recovery Plan is required, submit it and the SoC to the regulator, with a summary of the valuation
- prepare and issue annual summary funding statements to all members

3.2 SFO VALUATIONS

The SFO does not set out a prescribed set of actuarial assumptions which must be used in the valuation. The trustees are required to seek actuarial advice in choosing assumptions and, depending on the scheme rules, must consult or reach formal agreement with the employer concerning the assumptions used. The valuation must use an 'accrued benefits' actuarial funding method, such as the Projected Unit or Attained Age methods described in Part 4, Chapter 1.1.

The Code of Practice provides little guidance on the amount of funding that trustees should seek to achieve, other than that the technical provisions should be based on 'prudent' assumptions. The regulator has set out how it regulates the funding of DB schemes and the circumstances under which it might investigate schemes in its DB regulatory strategy and enforcement policies issued in June 2014. Since 2012, the Regulator has issued a statement each spring to help trustees understand its expectations for valuations within the prevailing economic conditions.

3.3 INTEGRATED RISK MANAGEMENT AND ASSESSING THE EMPLOYER'S COVENANT

One of the key aspects of the SFO is the requirement for the trustees to make an assessment of the employer's covenant (i.e., the strength of the employers' commitment to provide sufficient funding for the scheme). The requirements are set out in the Pensions Regulator's Code of Practice on funding defined benefits and its guidance on assessing and monitoring the employer's covenant, which was revised in 2015.

The Regulator expects trustees to form an objective assessment of the employer's financial position, prospects and its legal obligation to continue to fund the scheme's benefits.

The Regulator expects trustees to obtain information regarding the employer, both from the employer itself and from other sources, which might include credit rating agencies or specialist advisers.

The Regulator has also issued regulatory guidance outlining its expectations for an integrated approach to risk management. This complements the code of practice and employer covenant guidance.

The guidance describes Integrated Risk Management (IRM) as a tool to help trustees identify and manage factors that could impact on the scheme meeting its objectives. An IRM framework can inform trustee and employer decisions in relation to the overall strategy, within the risk capacity of the scheme and risk appetite of the employer. As part of a valuation, trustees need to take an integrated approach to scheme funding by considering together the risks to the scheme that arise from adverse experience on the funding assumptions, investment strategy or the employer covenant. So, the strength of the employer's covenant must be considered by the trustees in setting the assumptions used to calculate the technical provisions, in determining any recovery plan that may be needed and when considering the scheme's investment strategy.

The Pension Scheme Act 2021 requires trustees and sponsors to agree a long-term funding and investment strategy for a scheme. The new regime will lead to tougher funding standards, more de-risking, more contributions to pension schemes, and some scheme closures. If this leads to safer pensions, at a fair cost to employers, then this will fulfil the policy intent, but this remains to be seen and many are concerned about unintended consequences, particularly for open schemes. In the meantime, trustees and sponsors will need to have one eye on the likely new regime as they complete current valuations and review investment strategies and journey planning.

3.4 STATEMENT OF FUNDING PRINCIPLES (SFP)

The trustees must prepare the SFP within 15 months of the valuation date. It should be made available to members on request and should cover:

- the trustees' policy for ensuring that the SFO is met
- the methods and assumptions used
- the period over which any shortfall will be made up
- certain other information prescribed in The Occupational Pension Schemes (Scheme Funding) Regulations 2005/3377

3.5 RECOVERY PLAN

Where the SFO is not met, the trustees must achieve a full funding level over an acceptable period given the strength of the employer's covenant. The way this is to be achieved must be set out in a formal recovery plan and must be consistent with the approach set out in the SFP.

The Code of Practice identifies issues which trustees should take into account when considering the structure of the recovery plan. These include:

- the employer's business plan, expenditure commitments and sustainable growth plans
- the scheme's membership profile
- the position of the scheme if the employer were to become insolvent

Trustees should also consider the extent to which 'contingent assets' (e.g., a formal guarantee made by a parent company or a letter of credit) might form part of the recovery plan (see Part 4, Chapter 1.2.5). The recovery plan must state a date by which the scheme deficit is to be eliminated. If the plan covers a period longer than one year, the plan should also show the date by which half of the extra contributions due under the recovery plan will have been paid. Trustees must send a copy to the regulator.

3.6 SCHEDULE OF CONTRIBUTIONS

The Schedule of Contributions (SoC) must:

- set out the rates of contribution by members and the employer and also the dates on which contributions are to be paid
- identify any special contributions, such as those which form part of the recovery plan or are required to meet expenses
- be sufficiently clear to enable the trustees to monitor contributions
- avoid any cross reference to other scheme documents

The scheme actuary must certify that the SoC is fully consistent with the SFP and that the contributions are expected to be adequate to meet the SFO for the period covered by the SoC or will do so by the end of any recovery plan. It should cover a period of five years or, if there is a recovery plan in place that covers a period of more than five years, the length of the recovery plan. The trustees must ensure that contributions are paid in accordance with the provisions of the SoC. Any failure to comply should be investigated and, if necessary, reported to the regulator.

3.7 SUMMARY FUNDING STATEMENT

Trustees must issue a Summary Funding Statement to members within three months of the latest date for receiving a formal valuation report or annual actuarial report. This summarises the scheme's funding level and also contains information about the scheme's asset allocation and any recovery plan and provides guidance on where further information may be found.

3.8 SCRUTINY AND INTERVENTION BY THE PENSIONS REGULATOR

The Regulator does not have the resources available to scrutinise every scheme. It aims to focus on schemes that present the greatest risk of failing to meet their liability for the promised benefits.

The Regulator will consider aspects of the valuation such as the strength of the assumptions, the length and structure of the recovery plan and the trustees' assessment of the strength of the employer covenant compared with publicly available information.

While the trustees are responsible for producing the SFP, they will often need to obtain the agreement of the employer (depending on the scheme rules) when deciding on the assumptions used to calculate the technical provisions and where necessary setting the recovery plan. The regulator has stated strongly that it does not wish to become an arbitrator in cases where agreement proves difficult and formal intervention will not occur unless absolutely necessary. However, the regulator recognises that in some circumstances the objectives of the employer and trustees cannot be reconciled. If this is the case, it may consider imposing the following measures:

- obtaining a skilled person's report e.g., on the technical provisions
- modification of the accrual rate for future benefits
- issuing a direction on how the technical provisions are to be calculated
- issuing a direction on the operation of the recovery plan
- imposing a schedule of contributions
- issuing a freezing order whilst wind up is considered
- ordering that a scheme be wound up

Under the Pension Schemes Act 2021 for DB schemes, there are some significant additions to, and adjustments of, the current powers of the Pensions Regulator. Two new criminal offences are also created with no limitation on who could be in scope. The threat of the new criminal offences may pose real challenges to decision making by company directors and wider stakeholders in businesses sponsoring DB schemes (including lenders and shareholders). The offences have a much wider scope than those guilty of 'wilful or reckless behaviour in relation to a pension scheme. 'Failure to act' is also caught by the definition of the offences. Criminal penalties include unlimited fines and up to seven years in jail. The new contribution notice tests mean there will be the need for greater governance oversight and due diligence around dividend payments, refinancing, and restructuring – by both company directors and by trustees.

There may be a need to consider mitigation to the pension scheme under a wider range of corporate activities. Trustees will need to be able to show that they have asked the right questions, considered the sponsor's response (with appropriate advice where relevant) and documented their 'reasonable' decision making process.

3.9 THE PENSION PROTECTION FUND

Along with the Pensions Regulator and the SFO, the Pensions Act 2004 also introduced the Pension Protection Fund (PPF) (see Part 5, Chapter 2). The PPF was set up to provide some protection for members of DB schemes if their employer becomes insolvent after 5 April 2005.

If insolvency would result in a scheme going into wind up with insufficient assets to buy out the 'PPF benefits' of the members then, subject to certain criteria, the PPF will take responsibility for the scheme and the payment of the members' benefits.

The PPF does not provide the full benefits that would have been provided by the scheme. See Part 5, Chapter 2.5 for details of the benefits payable.

The PPF is funded by a levy on schemes that would be eligible for PPF compensation if the sponsoring employer becomes insolvent and the scheme winds up with insufficient assets. The pension protection levy each scheme must pay is partly based on the degree of underfunding in the particular scheme. See Part 5, Chapter 2.6 for more information on the levy.

To enable the PPF to determine the extent of any underfunding, Section 179 of the Pensions Act 2004 requires all eligible schemes to perform a 'PPF valuation'(also known as a 'Section 179 valuation') every three years and provide the results to the PPF via the regulator. This is normally, but not always, carried out at the same time as the Statutory Funding Valuation. The assumptions to use for a PPF valuation are market related and the derivation of the assumptions is set out in guidance provided by the PPF.

http://www.pensionprotectionfund.org.uk/documentlibrary/documents/s179%20assumptions%20guidance.pdf

This Section 179 valuation must be performed based on the scheme's benefit structure but taking into account key features of the levels of compensation available from the PPF. So, for example, where a scheme provides increases of LPI to a maximum of 5% on all pensions in payment, the Section 179 valuation is performed assuming that only pensions accrued after 5 April 1997 increase in payment and this increase is only LPI up to 2.5%. This reflects the level of increases that would be provided by the PPF. Pensions for members under NPA will also be adjusted to reflect the amount that the PPF would pay.

Summary

This chapter has explained the requirements of the Statutory Funding Objective (SFO).

Under the SFO, trustees have a number of responsibilities, including ensuring that a full actuarial valuation is produced every three years, based on prudent assumptions following actuarial advice and usually agreed with the employer.

When setting these assumptions, the trustees must assess the employer's financial position and its legal obligation to fund the benefits.

Following the valuation, the trustees must prepare a Statement of Funding Principles and, if the scheme does not meet the SFO, a recovery plan explaining how the scheme will eliminate the deficit. Trustees must also produce a Schedule of Contributions, detailing the rates of contributions due and the dates on which those contributions will be paid.

The regulator can intervene in the running of a scheme and will focus on the schemes that pose the greatest risk. The regulator has a range of powers, including imposing a Schedule of Contributions or even ordering that a scheme winds up.

The PPF provides some protection for members if their employer becomes insolvent, although it will not generally provide the full benefits that would have been provided under the scheme.

Self Test Questions

- Describe the items that should be included in the Statement of Funding Principles.
- Outline how the strength of the employer's covenant could affect the valuation assumptions set by the trustees.
- Explain when a scheme will need a recovery plan and describe the issues that the trustees should take into account when developing such a plan.
- Describe the measures that the Pensions Regulator may take if the trustees and the employee cannot reach the required agreement on the assumptions to be used to calculate a scheme's technical provisions.
- Describe why a PPF valuation is required.

CHAPTER 4

Company Accounts

INTRODUCTION

In this chapter, we will look at how the cost of providing a pension scheme is reflected in a company's accounts and the different accounting standards that can apply. As the cost of funding the scheme and the extent of any scheme deficit must be shown in the company's accounts, it is important to understand how the scheme can have a significant impact on the company's declared financial position.

After studying this chapter, you should understand how the financial health of the scheme is reflected in the company's financial statements and the various accounting standards that can apply.

4.1 ANNUAL REPORT AND ACCOUNTS

Probably the most important publication presented to the outside world by a company is its annual report and accounts. This is aimed primarily at investors who are concerned with the progress of the business, its prospects and profitability and the distribution of profit they receive as dividends.

There are legal limitations on the amount of dividends that may be paid. A public company may only pay a dividend if its net assets after paying the dividend are not less than the total of it's called-up share capital and distributable reserves. This is a potential problem for any company with a pension fund deficit that is large in relation to its net assets if the deficit is reflected in the accounts.

The financial statements contained within the report and accounts include:

- the balance sheet, which is a snapshot of the financial position of a company at a single point in time
- the profit and loss account, which gives information about a company's financial performance over the reporting period

The statements must give a true and fair view of the company's financial position and performance, be prepared using appropriate accounting policies and follow all applicable accounting standards.

4.2 UK ACCOUNTING STANDARDS – FRS 100, 101 AND 102

The group accounts of listed UK companies must be prepared using International Financial Reporting Standards (IFRSs – see Part 4, Chapter 4.3). However, accounts prepared under the Companies Act 2006 may follow either IFRSs or the UK accounting standards (Financial Reporting Standards - FRS) issued by the Accounting Council of the Financial Reporting Council (FRC). The previous reporting standard, FRS 17, ceased to exist for periods from 1 January 2015 and was replaced by FRS 100, 101 and 102.The basic objective of these accounting standards is to ensure that an accurate picture of the financial impact of the pension arrangements is provided.

Pension accounting under FRS 101 is very similar to the full International Standard (see Part 4, Chapter 4.3) and FRS 102 is a "lite" version of this with much reduced disclosure requirements.

Under the standards the pension fund recoverable surplus or any deficit is calculated using assumptions set in accordance with the accounting standard and must be shown on the balance sheet.

The profit and loss account must also reflect the costs of the scheme, including:

- the cost of benefits being accrued
- the cost of any improvements granted to scheme members
- the expected increase in the value of benefits already accrued, including pensions in payment
- the expected increase in asset values due to expected investment returns

The costs of the scheme therefore directly affect the declared profit or loss of the sponsoring company.

4.3 INTERNATIONAL AND US ACCOUNTING STANDARDS

International accounting standards are produced by the International Accounting Standards Board (IASB). The IASB itself has no authority to require compliance with its accounting standards, however, many countries or supranational authorities such as the European Union require the financial statements of publicly traded companies to be prepared in accordance with its International Financial Reporting Standards (IFRSs). Companies listed on a European stock exchange must prepare their consolidated financial statements using IFRSs.

International Accounting Standard 19 Employee Benefits (IAS 19) covers employee benefits including postretirement benefits such as pensions and how these are reflected in the company's accounts. The requirements under amended IAS 19 are broadly consistent with FRS 101 (see Part 4, Chapter 4.2), although some differences remain.

The US Financial Accounting Standards Board (FASB) has its own accounting standard for pension benefits for companies listed on the US stock exchange. All US accounting standards (not just those for pensions) are consolidated into the FASB Accounting Standards Codification. This is available online and the relevant section for pensions is Section 715 on 'Compensation – Retirement Benefits'. Many of the principles of the US standards are similar to IAS 19, but there are differences, in particular in the treatment of surpluses and deficits.

The IASB and the FASB are working on a convergence project to make their accounting standards more consistent with each other. Completion is likely to take several years yet.

Summary

Pension scheme surpluses or deficits must be reflected in a company's financial statements. There are various international accounting standards that specify how pension scheme costs must be treated, which aim to ensure that the financial impact of the scheme is accurately reflected in the financial statements.

Self Test Questions

- Describe the significance of FRS standards.
- Describe the significance of IAS 19.

CHAPTER 5

Actuarial Factors and Transfer Values

INTRODUCTION

So far in this Part, we have looked at issues surrounding the overall funding of a scheme. Ultimately the scheme exists to pay benefits to individual members. In this chapter we will look at the actuarial factors required to calculate benefits for members who retire before or after their normal pension age or who want to exchange some of their pension for a cash lump sum.

We also consider the factors required in the calculation of individual transfer values and the approaches used when a group of members transfers from one scheme to another.

Understanding how actuarial factors may determine the benefits available and how benefits are valued for transfers is important as these issues directly affect the benefits payable to individual scheme members. When establishing the appropriate level for the factors, the rules of the scheme and principles such as fairness, prudence and pragmatism must be considered.

After studying this chapter, you should understand how actuarial factors can impact on the benefits for individual members and how benefits may be valued when they are transferred.

5.1 EARLY AND LATE RETIREMENT

5.1.1 Early Retirement

Members generally have the option to take their benefits before they reach normal pension age (NPA). Where early retirement occurs, the pension is usually reduced to allow for the fact that it is being paid early.

The early retirement reduction will take account of the fact that, as it is coming into payment before NPA, the pension is likely to be in payment for longer. Also, the funds backing the pension have been invested for a shorter period. The reduction can be applied on a 'cost neutral' basis. This means that the reduction factors are in line with the assumptions in the ongoing valuation basis. The resulting early retirement pension will then have the same overall value as the expected normal retirement pension.

Early retirement provisions will be set out in the scheme rules. The rules will specify who has the power to set the factors. This may be the trustees or sponsoring company, although the advice of the scheme actuary will usually be required. The factors should be reviewed periodically to ensure they remain appropriate. Such a review often takes place following a valuation.

Occasionally the scheme rules will set out the reduction factors to be applied or detail circumstances where the early retirement pension can be taken unreduced, for example when the member is retiring early on grounds of ill health (see Part 2, Chapter 3.1.5).

5.1.2 Late Retirement

Where a member retires after NPA the initial payment is often increased to allow for the late payment. This increase can be calculated using a 'cost neutral' approach in a similar way as for early retirement and again the scheme rules will set out the provisions for late retirement and specify who has the power to set the factors.

To date, as late retirement has generally been less common than early retirement, a simplified set of factors is often used for administrative ease.

5.2 COMMUTATION

In DB schemes without an automatic cash benefit, members are often given the option to exchange or 'commute' some of their pension for a cash sum.

Again, the scheme rules will determine who has the power to set the terms, but the advice of the actuary is usually required. The factors will allow for assumed life expectancy and projected pension increases as well as discounting the future payments to present value.

The factors may be set on a cost neutral basis, and they should be reviewed periodically. Commutation is an option for the member and there is no requirement for schemes to set factors at a given level.

5.3 INDIVIDUAL TRANSFER VALUES

Members who leave a pension scheme before retirement usually have the right to transfer the value of their benefits to another pension arrangement. The amount transferred is called the 'Cash Equivalent Transfer Value' of the member's deferred benefits.

The Pension Schemes Act 2015 introduced changes to the right to a statutory transfer so that a member has transfer rights in respect of each category of benefit. The three categories are DC, cash balance and any other benefit type (e.g., final salary or career average). This means that members who have a mix of benefit categories within a particular scheme have a statutory right to take a partial transfer in respect of each of these categories in isolation. There are a number of conditions that apply, including that the member has ceased accruing that category of benefit and that the benefits for that category are transferred in full. This means that schemes that previously did not allow partial transfers in any form now need, as a minimum, to permit partial transfers for a particular benefit category.

In addition to the statutory requirements, schemes may also consider whether a further option should be made available to members, to enable them to take a partial transfer value in respect of a portion of their DB pension so they could retain part of their DB pension in the scheme. Whether and how these are allowed for within a scheme is for the trustees to decide, in consultation with the employer and after advice from the scheme actuary. The rules of the scheme also need to be checked to ensure they do not prohibit partial transfers.

Legislation requires that the cash equivalent (whether in respect of all the members' benefits, or only part of them) should represent the value of the benefits which would otherwise have been preserved for the member.

5.3.1 Basis of Calculation

The actuarial value of the benefits which would otherwise be preserved for the member should represent the expected cost to the scheme of providing the benefits (although there are circumstances where a lower amount may be paid – see Part 4, Chapter 5.3.2). The discount rate used must be based on market rates of return and should have regard to the scheme's investment strategy.

The trustees must decide on whether discretionary benefits, such as pension increases, are to be taken into account and, if so, to what extent. They need to consider any established custom or stated policy for granting them and whether consent (e.g., from the employer) is required.

If the scheme rules include any provisions that allow deferred members to exercise an option which would increase the value of their benefits, the transfer value should be based on the assumption that the member would use that option.

Example

A scheme has an NPA of 65, but deferred pensioners have a right to take their benefits from age 60 with no reduction to pension.

The transfer value calculation must be based on retirement at age 60, as this is the most valuable option for the scheme member.

Allowance may be made for expenses, whether costs or savings. For example, the scheme may save some administration costs in the future if the member takes a transfer, and it may incur costs if there is a need to sell investments to pay the transfer value.

5.3.2 Performing the Calculations

The current requirements for calculating transfer values came into effect from 1 October 2008. Legislation sets out that:

- trustees are responsible for choosing the method and assumptions used to calculate transfer values, having taken advice from the scheme actuary
- assumptions can be determined on a 'best estimate' basis and the discount rate should reflect the expected return on the existing asset mix of the scheme
- trustees can reduce transfer values if the scheme is underfunded against a transfer value test, and they have received an 'insufficiency report' from the scheme actuary

5.3.3 Incoming Transfer Values

The benefits granted on receipt of a transfer value into a scheme must be determined using methods and assumptions which are consistent with those used by the scheme to calculate outgoing transfer values. In schemes which grant added years of service in return for a transfer, one further assumption - an allowance for salary increases - is needed.

In general, there is no legal requirement for schemes to provide transferred in benefits in a particular form, provided that they are equivalent in value to the transfer received. Some schemes provide added years of service; some provide an element of fixed pension, and some treat the transfer as a DC benefit, crediting it with investment returns.

Scheme members do not have a legal right to transfer benefits into an occupational pension scheme. The trustees and/or employer can decide whether or not they wish to accept individual transfer values.

Processing an incoming transfer value has become administratively complex and many employers/trustee bodies no longer accept incoming transfers.

5.4 BULK TRANSFER VALUES

Sometimes large groups of employees are transferred from one scheme to another. This could happen following the sale or purchase of a business, or on the merger of two pension schemes.

Special terms often apply to the transfer values paid in these circumstances. This is done partly because the employees involved have not left the pension scheme of their own volition, and it is generally accepted that they should not be disadvantaged by the transaction.

5.4.1 Types of Transfer Payment

Leaving Service Transfer

If employees have changed employer, then trustees can treat them as early leavers and offer them the transfer value available to individual members on leaving service. In most cases this figure will be lower than the alternatives below.

Past Service Reserve

A more generous approach is to offer scheme members a 'past service reserve' transfer. This includes allowance for future salary increases and represents the liability to the fund which would apply if the members were assumed to continue in service.

Share of Fund

The 'share of fund' transfer equals:

Liability for Transferring Members x Value of Scheme Assets/ Total Scheme Liabilities

There are variations on this formula. For example, some liabilities and assets may be excluded before the ratio is calculated.

This formula may be used when:

- a scheme has a surplus, and the buying company is seeking a share of the surplus, or
- a scheme has a deficit, and the selling company wants to export some of the deficit

Example

The Colourboxx Final Salary Plan (CFSP) has two small sections with different benefit structures from the main section, to accommodate staff taken on during two of the company's acquisitions. The Colourboxx Cosmetics Retirement Benefits Scheme (CCRBS) also has a different benefit structure from the CFSP.

It is likely that the two sections of the CFSP were set up when businesses were bought - the businesses will have participated in a larger scheme and a bulk transfer will have been paid out of that scheme. Rather than establish a new scheme from scratch the company will have set up these sections to receive the transfer and the value is likely to have been calculated on either the past service reserve or the share of fund basis.

On the other hand, the CCRBS will have been acquired when Colourboxx bought a company complete with its own existing pension scheme - a bulk transfer was not required as the scheme was already established.

CHAPTER 6

Investment Strategy

INTRODUCTION

In a DB scheme, the level of pension an employee receives in retirement is based on two factors: the length of their pensionable service and their salary. In a 'Final Salary' scheme the salary used in the pension calculation is typically that from the final year(s) of service. However, in a Career Average Revalued Earnings scheme the salary is generally averaged over the member's entire pensionable service. The employer makes contributions to the scheme and trustees (or their equivalents) are appointed to look after members' interests. The scheme may also require employees to make contributions.

A DB scheme carries a number of key risks for the sponsor. There is risk in valuing the liabilities over the long term in that the assumptions used might not reflect actual experience (e.g., mortality, salary inflation, etc.). There is short-term risk in respect of the value placed on those liabilities, which rise and fall with gilt yields, and which impacts the required contribution rate, and there is risk in terms of poor investment performance which can also impact contribution requirements for the sponsor. In addition, the employer will have to show any pension deficit on their balance sheet from an accounting perspective. Depending on the size of the scheme, this can significantly skew the picture of a company's overall financial health and potentially damage its commercial interests.

The trustees of the pension scheme have the responsibility for a scheme's investment objectives and strategy. Their ultimate objective is to ensure that the scheme's assets are sufficient to cover the scheme's pension liabilities. Before they can decide on an appropriate investment strategy (i.e., asset mix), they require a detailed analysis of a scheme's pension liabilities as discussed earlier in this Part. Once the liability cash flow profile is modelled, trustees need to take into account a number of factors to determine the appropriate investment strategy, such as the scheme's current funding level, the strength of the employer's covenant and the employer's and the Trustees' own attitude to risk.

At the end of this chapter, you should understand how the trustees of a DB scheme should go about setting an investment strategy for the scheme and the various factors the trustees need to take into account when doing so.

For background material on the different types of investments available to DB pension schemes and their tax treatment, students should refer to the relevant chapters in Core Unit 4, Financing and Investing for Retirement Provision.

6.1 FACTORS AFFECTING INVESTMENT STRATEGY DECISIONS

The trustees' choice of investment strategy depends on a number of factors, such as the size of the scheme, the current funding level and the strength of the employer covenant and should be considered within an integrated risk management framework.

6.1.1 Size of Scheme

Trustees of small schemes generally invest the scheme's pension contributions in insurance contracts. Until a pension scheme's assets reach a certain size, the costs and difficulties associated with benefit administration, the payment of benefits and legal aspects usually outweigh investment considerations. With an insurance contract, the insurance company takes care of these matters including the choice of investment strategy and all the contributions are paid into such a contract.

When a scheme's assets grow beyond a certain size, the trustees usually start to consider alternatives to insurance contracts and assume responsibility for setting the investment strategy (i.e., the long-term allocation to specific asset classes). A key consideration in determining appetite for risk is the strength of the employer covenant (see Part 4, Chapter 6.1.3) and a key influence on this is the size of the scheme relative to the size of the sponsor. Simply put, the larger the scheme relative to the sponsoring employer the larger the potential financial impact of the pension scheme on the employer's activities and therefore the sponsoring employer may not be able to underwrite a significant level of investment risk.

6.1.2 Funding Level

Scheme in Surplus

Although trustees of a scheme with a surplus of assets over liabilities have scope to follow a higher risk/return seeking strategy, there is little value in building up a large and growing surplus. A large surplus may ultimately be refunded to the scheme's sponsor less a tax charge, depending on the rules of a particular scheme.

Instead, trustees should aim to maintain a small surplus, to provide a cushion to manage unexpected funding shortfalls. The trustees should keep in mind their ultimate funding level target which may be stronger than the current technical provisions basis. Along with the difficulties of estimating the future value of a scheme's liabilities, which depends on uncertainties such as life expectancy and salary increases, funding shortfalls can be caused by regulatory changes and poor market conditions. In addition, a small surplus may enable additional, discretionary benefits to be paid. These could include a more generous indexation of pension income from retirement above the statutory minimum. The additional funds could also be used to augment a member's retirement benefits on early retirement, redundancy, or ill health.

Perhaps more common though in the current environment is for the trustees to use the opportunity to take less investment risk thereby improving the security of the members' benefits. A lower level of investment risk will likely lead to changes in the actuarial funding basis used to value the liabilities (such as a lower discount rate reflecting the lower expected future return on the assets) which in turn places a higher value on the liabilities and erodes the surplus.

Scheme in Balance or in Deficit

If a scheme has only just sufficient assets to meet its liabilities, or is in a small deficit, or employer covenant is weak (see Part 4, Chapter 6.1.3), the trustees may be more likely to follow an asset allocation policy that is closely matched to the scheme's liabilities, as it is less able to withstand dips in asset values. Return seeking investments can be added to a matching strategy to generate returns in excess of the projected liability cash flows in order to close a funding gap. However, the risks of such a strategy will need to be taken into account.

For most pension schemes a small deficit is not problematic, and usually a combination of investment returns, and sponsor contributions can absorb it. However, a large or growing deficit causes many problems. Along with the negative impact on the sponsoring company's balance sheet, as losses accrued in the pension scheme are reflected in the company accounts (see Part 4, Chapter 4.2), contribution levels will have to be increased significantly (which the sponsoring company may not always be able or willing to pay). As well as leading to possible member disquiet, a larger deficit will bring about increased regulatory scrutiny. A large deficit may also lead to a less matched investment policy, in pursuit of higher returns

to correct the deficit, as the risk of further volatility in funding level may be preferable to the increased contributions required, particularly if the employer's covenant is strong. A less matched/ higher risk investment policy may also be required if the employer's covenant is weak, as the required contributions to meet the deficit may not be available.

6.1.3 Strength of the Employer's Covenant

The strength of the employer's covenant refers to the ability and willingness of the scheme's sponsoring employer(s) to meet their funding obligations and, in particular, their ability to meet these obligations when investment performance is poor. Trustees and sponsors should aim to quantify the critical funding level, below which a funding shortfall becomes financially unmanageable for the sponsor. The following factors can be taken into account to determine the critical funding level (this list is not exhaustive):

- the size of the scheme relative to the company
- the sponsor's credit rating (i.e., the company's ability to service its debt)
- the sponsor's maximum contribution level
- target events such as changes in stock markets, interest rates or inflation expectations
- demographic events such as increased longevity

Trustees are expected to assess the strength of the employer's covenant and to monitor it on an ongoing basis. A number of organisations now offer covenant assessment services to pension scheme trustees.

Assessing covenant strength involves gathering appropriate information. Published data about historic performance is helpful to some degree, but much more important will be management information provided by the employer (on a confidential basis) about past performance and forecasts of future performance.

The following considerations are relevant to an assessment of employer covenant:

- **Scheme size:** The size of the pension scheme in relation to that of the employer is an indicator of covenant strength. If the scheme is large in relation to the employer, then it is financially more significant and that may be a sign of covenant weakness when combined with other factors
- **Profitability:** The history of profits and future profit forecasts will indicate if the employer has a sound ongoing business
- **Cash flow:** Profits are only part of the story. The pension scheme needs cash funding and the ability of the employer to generate sufficient cash for its business needs as well as for the pension scheme is important
- **Balance sheet:** The availability of assets to fund the shortfall in the event that the employer goes out of business (after allowing for other creditors with higher priority) will be important only if the trustees have serious concerns about the future viability of the employer. It is rare for an employer to have sufficient assets in such circumstances, but the extent of the shortfall indicates the proportion of scheme benefits that are at risk

There are various ways in which the strength of employer covenant can be improved, thereby reducing covenant risk, and it has become very common for trustees to discuss these with the employer during funding negotiations. Some common examples are as follows:

- **Charge on assets:** For example, land or buildings. The trustees would take ownership under specified circumstances normally in the event of employer insolvency. The ability and willingness of an employer to offer such a 'contingent asset' will depend on the specific circumstances
- **Parent company guarantee:** The parent company may be much larger than the sponsoring employer but would normally have no legal obligation to finance the scheme. A legally binding guarantee would commit the parent company to provide financial support up to a pre-agreed level in specified circumstances, again typically in the event of employer insolvency, or if the employer were unable to meet its agreed funding commitments to the scheme
- **Escrow account:** the employer places money in a separate account, to which it has access only in specified circumstances. The trustees will then have access to the money held on escrow in specified circumstances, such as employer insolvency

These are just a few examples, and there are a number of others which can be explored, depending on the specific circumstances.

Some of these arrangements (e.g., charge on assets or parent company guarantee) can be recognised by the Pension Protection Fund (PPF) and used to reduce the levy paid to the PPF (see Part 5, Chapter 2.6.2).

6.2 ROLE OF REGULATION AND LEGISLATION

There have been a number of significant developments in pension fund regulation in recent years and changes to pension fund accounting regulations have placed liabilities under far greater scrutiny than in the past. The new regulations set out common accounting standards.

In addition to rules regarding the accounting and valuation of pension schemes, a regulatory framework was set out to counteract the underfunding of pension schemes. UK pension schemes saw a marked deterioration in their funding levels from 2007 to 2009, as falling interest rates led to an upward revision of pension liabilities, while a period of weakness in equity markets led to a downward revision in pension assets. This highlights the effect an equity market slowdown can have on the wider pension sector.

The Pensions Act 2004 created the Pensions Regulator, which has increased legislative powers to intercede in schemes that are running into underfunding issues, and the PPF was introduced to provide a solution to significantly underfunded pension schemes whose sponsoring employer is insolvent. In particular, the PPF will pay compensation to members of such schemes.

Pension fund trustees have come under increasing scrutiny, with regulation and guidelines aiming to increase trustee knowledge and understanding of their own scheme documentation, pension law and trust law, the funding principles of occupational pension schemes and the investment of the assets in such schemes. The Pensions Act 2004 requires trustees to ask for professional advice on any matters that they do not understand and on technical issues which may affect the scheme. With many UK schemes still in deficit, trustees are now obliged to ensure that investments are contributing towards deficit reduction and meaningfully improved funding positions in the future.

For DB schemes, following The Pensions Act 2021 there are some significant additions to, and adjustments of, the current powers of the Pensions Regulator. Two new criminal offences are also created with no limitation on who could be in scope. The threat of the new criminal offences may pose real challenges to decision making by company directors and wider stakeholders in businesses sponsoring DB schemes (including lenders and shareholders). The offences have a much wider scope than those guilty of 'wilful or reckless behaviour in relation to a pension scheme' (what had originally been proposed). 'Failure to act' is also caught by the definition of the offences. Criminal penalties include unlimited fines and up to seven years in jail. The new contribution notice tests mean there will be the need for greater governance oversight and due diligence around dividend payments, refinancing, and restructuring – by both company directors and by trustees. There may be a need to consider mitigation to the pension scheme under a wider range of corporate activities. Trustees will need to be able to show that they have asked the right questions, considered the sponsor's response (with appropriate advice where relevant) and documented their 'reasonable' decision making process.

6.3 EMPLOYER AND TRUSTEE ATTITUDE TO RISK

The financial consequences of the investment decisions made by the trustees have an impact on the sponsoring employer, as deficits accrued in a company's pension scheme are reflected in the sponsoring company's balance sheet and the employer may be called upon for additional contributions to help fund the deficit. Although the trustees do not need to follow the employer's instructions when setting investment policy, they must take into account the employer's attitude to risk, and how the scheme's investment strategy could potentially impact the covenant. For example, they need to answer the following questions:

- does the employer wish to pay a stable rate of contribution whenever possible?
- is there an upper limit to the level of contribution the employer is prepared to pay?
- if contributions had to exceed this level, what action would the employer take - scheme closure, reduction of future benefit accrual?
- what effect does the investment strategy have on the company's accounts?
- is the employer willing to take on the risk for the trustees to follow a mismatching policy in anticipation of lower long-term costs (i.e., through higher investment returns), with its consequent greater risk of higher contributions from time to time?

Trustees must not act in a way that jeopardises the security of members' benefits, and so they should not embark on an investment policy involving more than the minimum degree of risk unless they are comfortable that the sponsoring employer is able and willing to provide financial backing.

6.4 CASHFLOW REQUIREMENTS

In schemes where contribution income exceeds benefit outgoings, monthly benefit payments are usually made before contributions are forwarded to the investment managers. Young schemes, with few pensioners relative to the number of active members, would be in this position.

Other schemes may need to supplement contribution income with investment income to meet benefit outgoings. This could be because the scheme has a high proportion of pensioners relative to active members, or because the sponsoring employer is enjoying a contribution reduction or holiday. In these circumstances, the trustees need to hold investments that generate a certain level of income, so that benefits can be paid without having to sell investments.

The most reliable sources of income are gilts, corporate bonds, and cash. Equities are less suitable because dividend levels vary and, at an aggregate level, often yield less than bonds and cash (although they offer increased potential for capital growth). Property can provide both income and capital growth, but the illiquid nature of the market can cause problems.

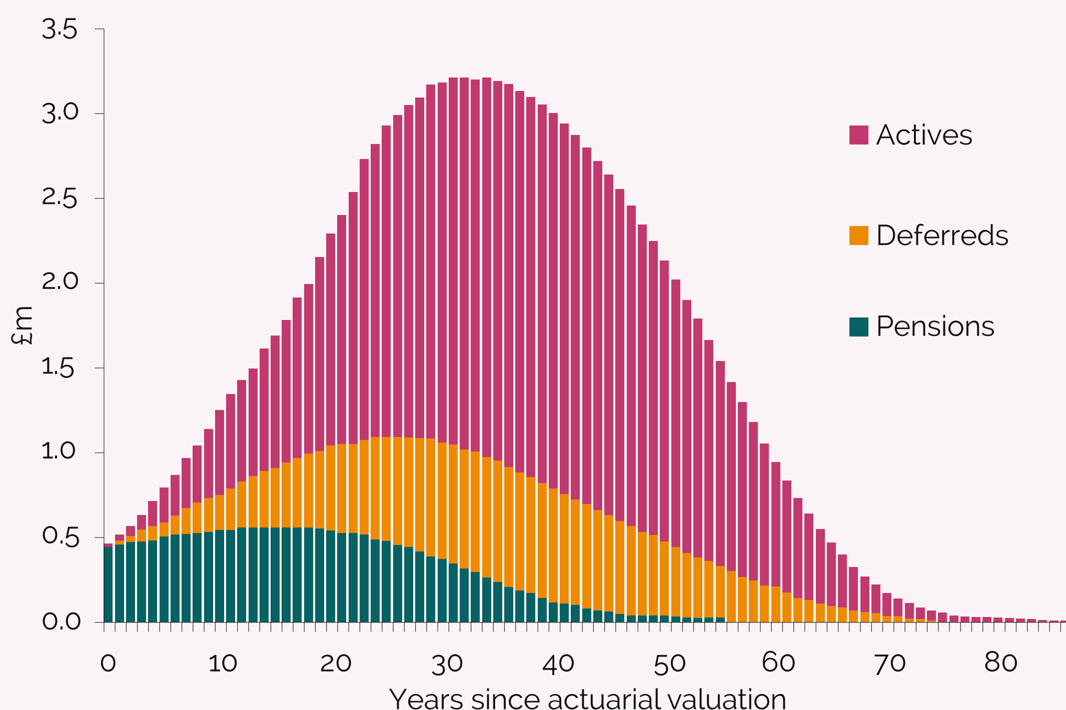
In a particularly mature scheme, where the bulk of the liabilities relate to pensioners, it may be necessary to sell investments from time to time to meet benefit payments. Careful planning is required in these circumstances. The trustees would need to ensure that their investment managers are informed well in advance of the need to sell. If sales are required on a regular basis, the investment managers could institute a planned programme of selling designed to eliminate as far as possible losses arising due to market conditions at date of sale. The managers could, for example, move part of the portfolio into gilts close to their redemption date, as gilts nearing redemption tend to be less volatile than the rest of the bond market.

6.5 LIABILITY PROFILE

Pension liabilities are a stream of current or future cash payments required to fulfil the pension promise made to scheme members. The cash flow profile of liabilities is comparable to that of a bond, but in reverse. While bonds provide a regular and predictable stream of future income payments, liabilities represent a regular and more or less predictable stream of payouts. Pension schemes require assets that provide a cash flow profile similar to that of their liabilities.

A scheme's liability profile can be constructed by modelling each projected cash flow as a series of financial instruments, such as zero-coupon bonds, that capture, as accurately as possible, both the timing and sensitivity of the scheme's liabilities to changes in market factors, such as interest rates and inflation.

The diagram below gives an indication of how a liability cash flow profile for a UK scheme might look.

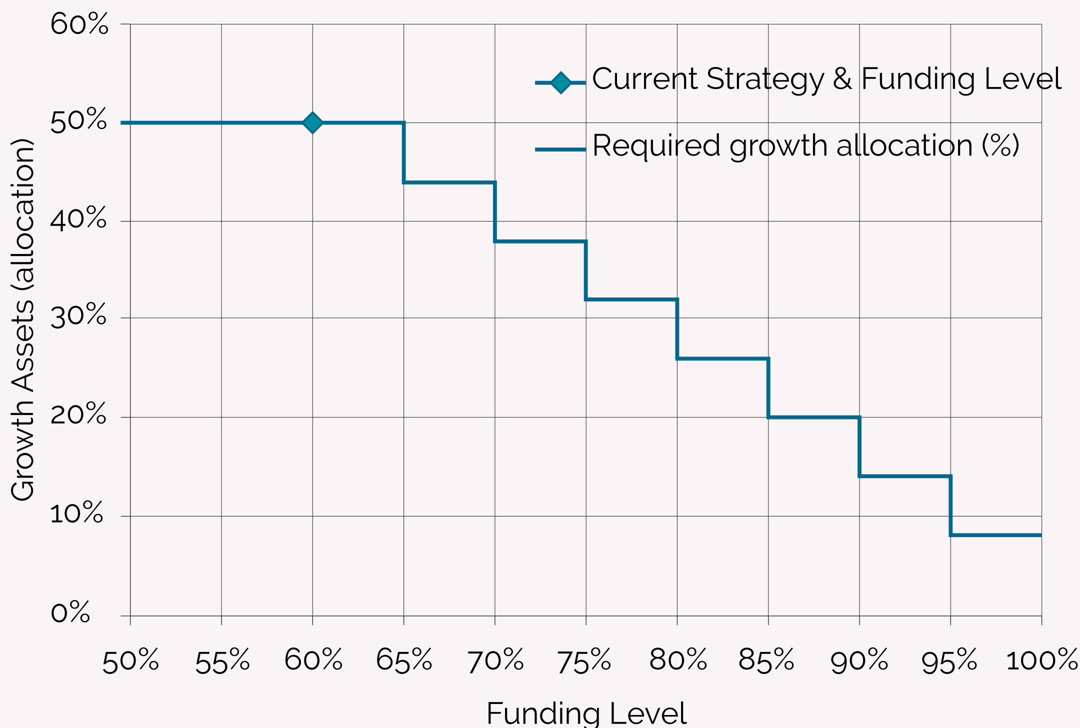


6.6 ASSET LIABILITY MODELLING

Asset Liability Modelling is the process of analysing a scheme's liability profile against a range of asset portfolios with different risk/return profiles. The results show the likely progression of the scheme funding level under these various scenarios. This modelling is a powerful technique in that it provides trustees with a framework for discussion in terms of devising a long-term investment strategy.

6.7 DE-RISKING

Traditionally Asset Liability Modelling was carried out every three years following an actuarial valuation with somewhat static goals. More recently trustees have looked to take a more dynamic approach, with many adopting a de-risking strategy. A de-risking strategy effectively looks to take risk off the table by moving the assets towards a portfolio of assets that better match the characteristics of the scheme's liabilities. This often involves setting defined targets (in terms of the funding level) which will trigger a de-risking action (such as switching growth assets into better matching assets such as bonds and/or liability driven investment (LDI) solutions which are discussed in Part 4, Chapter 6.8.1). An example of a de-risking plan is set out below.



Example - Funding Level Triggers

1. The starting position is a funding level of 60% with 50% of the assets invested in growth assets.
2. Seven funding level triggers are then set to progressively de-risk the scheme from investing 50% in growth assets to around only 8%.
3. The first funding level trigger is set at 65%. Once this funding level is breached, the allocation in growth assets is reduced by around 6% to 44%. The next funding level trigger is set at 70% when the growth assets will be reduced by a further 6% and so on.
4. Often the definition of the funding level will be one that already assumes the scheme has de-risked and which may differ from the Technical Provisions basis (for example a gilts +0% p.a. basis).
5. De-risking triggers are usually set at a level that allows a low-risk investment strategy without requiring more contributions from the employer. This is achieved by setting the de-risking triggers at a level which capture gains that are better than expected in the Technical Provisions funding basis.
6. It is important that de-risking triggers are reviewed regularly to ensure that they continue to be appropriate.

6.8 APPROACHES TO MANAGING RISK

Investing in bonds and Liability Driven Investment solutions can protect a scheme against financial risks such as movements in inflation and interest rates. There are also some derivatives on the market to deal with other risks that pension schemes face, such as longevity.

Insurance companies offer solutions to reduce and even remove the risk associated with pension schemes through buy in and buy out policies.

6.8.1 Liability Driven Investment

A scheme adopting a liability driven investment (LDI) strategy will aim to ensure that as the value of its liabilities changes, there is a corresponding change in the value of the assets held. They have come to prominence in recent years as the appetite for risk amongst employers and trustees has fallen (primarily because schemes have closed and become more mature, reducing the time horizon for investment and as gilt yields have fallen). In looking to manage risk there is the volatility in the assets and the volatility in the value placed on the liabilities. LDI strategies are one way of hedging out the volatility in the liabilities.

Key Components of an LDI Strategy

There are typically two key components to an LDI strategy: one that seeks to match liabilities and one that aims to generate growth. The core portfolio is designed to replicate the profile of a scheme's liabilities and, specifically, their sensitivity to two risk factors: changes in interest rates and inflation. This component may be built from a combination of fixed income and index linked bonds (that match fixed, and inflation linked pension payments), together with bond-based derivatives such as interest rate and inflation swaps, gilt repurchase agreements and total return swaps.

An interest rate swap is where two parties agree to exchange cash flows, based on a specified notional amount. One set of cash flows is based on a fixed interest rate (say 5%p.a.) and the other on a variable rate (say the London Interbank Offered Rate (LIBOR) plus 1.5%p.a.). Similarly, an inflation swap is where two parties agree to exchange cash flows where one set of cash flows is a fixed amount and the other is linked to inflation.

A gilt repurchase agreement (or gilt repo) is where a gilt (i.e., a UK government bond) is sold to another investor and later repurchased. The seller of the gilt retains exposure to the gilt (in terms of any change in its value) and the capital received can be used – in an LDI context – to buy more gilts, thereby leveraging the gilt exposure.

A total return swap is simply an agreement for two parties to pay one another the difference in performance from any two different return streams. In this example it could be the difference between the return on cash and the return on a gilt index.

The advantage of a derivatives based LDI solution is that it can be 'unfunded' meaning a smaller amount of capital can be used to hedge a larger proportion of the liability risk. The capital required is that necessary to settle any profit or loss rather than the value of the liabilities being hedged – this is known as collateral. If the liability value goes up the derivative solution makes a profit, offsetting the negative impact of a higher liability value to the funding level. If the liability value goes down the derivatives make a loss, but for the pension scheme this is less of an issue given the value of its obligations has also fallen (so from the funding level perspective it is cost neutral).

While not all LDI strategies will use derivatives, they do enable much more effective liability matching and they can free up capital to invest in assets that look to achieve a higher return, which may be necessary if the scheme is underfunded.

The growth-seeking component, meanwhile, may invest across a diversified range of asset classes, markets and strategies in order to generate consistent long-term investment returns to help reduce any funding deficit. The growth-seeking component is relevant for most schemes, not only because they are rarely fully funded but also as a means of protecting against changing variables. Since pension liabilities are effectively actuarial estimates based on a number of assumptions, it is prudent to aim to be over funded in order to avoid future shortfalls as a result of changing projections, such as mortality rates.

The Risk/Reward Trade-off

LDI does not remove all investment risk, but rather reduces the risk arising from the difference in sensitivity to interest rates and inflation between a scheme's assets and its liabilities. A traditional investment approach, which typically involved a high exposure to equities, leaves schemes open to a variety of risks, including those associated with the fund manager, equity markets, interest rates, inflation and longevity. Whilst equity market risk often receives the most attention, a greater degree of risk to funding levels actually comes from interest rate and inflation exposure. Even investment in a portfolio of conventional gilts and other bonds does not match the interest rate sensitivity of most schemes.

An LDI approach will help to ensure that those two key risks are mitigated through the use of derivatives, such as swaps. Interest rate risk is mitigated by increasing the sensitivity of the assets to interest rate movements, while inflation risks can be hedged to a considerable degree. However, LDI does not address the risk that longevity may be different from that assumed in the actuarial valuation of liabilities.

LDI Suitability

Given that the main objective of any DB scheme is to be able to meet its liabilities, LDI is relevant in principle to all DB pension schemes. While minimum size and cost limitations may have previously restricted access to LDI primarily to large, segregated schemes, pooled LDI solutions now enable smaller schemes to benefit from this innovative management approach in a cost-effective way. The approach to defining the LDI benchmark for a pooled scheme is exactly the same as for a segregated mandate. The principal difference is that a smaller scheme's portfolio will comprise a combination of pooled components rather than segregated assets. These can be combined with a return-seeking component, as outlined above.

A low level of initial funding need not necessarily be a barrier to implementation provided that a deficit recovery plan of sufficient size, speed and certainty is put in place and the lower returns from LDI strategies are adequately reflected in the assumptions used in the actuarial valuation. The use of unfunded derivatives to introduce gearing may allow underfunded schemes to manage a greater proportion of interest rate and inflation risk, but these instruments carry their own risks which the trustees should understand prior to investing (for example there is a cost of using such instruments and there is a risk that the cost makes them prohibitive).

LDI is a solution-based approach to investing, as opposed to an off the shelf product. Each scheme will have unique requirements and the investment strategy would need to be correspondingly bespoke. There are significant costs and operational issues involved in setting up an LDI strategy, as well as counterparty risks and inflexibility to be considered. Finally, the long-term costs in terms of higher ongoing contributions to finance risk reduction also need to be considered.

6.8.2 Longevity Swap

Under a longevity swap, a scheme agrees to make a fixed series of future payments to an insurer, bank or other financial institution ('the counterparty') who in turn agrees to make payments to the scheme covering future pension instalments as they fall due. In this way, the risk of extra costs arising because pensioners live longer than expected ('longevity') is transferred from the scheme to the counterparty.

The Risk/Reward Trade-off

A longevity swap removes the risk that a pensioner will live longer than expected and receive a pension for a longer period of time. The cost of this increased certainty to the scheme could be a relatively small strain or decrease in expected return but will be dependent on the scheme and the terms of the swap.

Longevity Swap Suitability

Although a longevity swap is in some ways similar to a buy in (see below), one attraction for schemes is that, unlike a buy in, the cost is spread into the future as the scheme makes a series of future payments to the counterparty rather than incurring the full cost now.

In recent years longevity swaps have become more popular in the market, again primarily restricted to the larger pension schemes due to cost. However, as the market in this area develops solutions are becoming available for the smaller schemes to hedge their longevity risk.

When coupled with an LDI solution, longevity swaps can help schemes mitigate their interest rate, inflation and longevity risks and provide a long-term solution for risk management (this is sometimes referred to as a synthetic buy in – discussed further below).

6.8.3 Buy Ins and Buy Outs

There is an increasing trend for schemes to transfer the liability for pensions in payment, and possibly for deferred members too, to insurance companies by 'buying out' or 'buying in' the benefits. For a fixed cost now, the scheme can transfer the risk of the unknown future cost of funding the pensions to the insurer.

Under a buy out arrangement, the members whose benefits are bought out become policyholders of the insurer and their connection with the scheme ceases. Under a buy in arrangement, the scheme simply insures its liability for the payment of pensions, so that the members remain members of the scheme but the financial and longevity risk of providing those pensions is transferred to the insurer.

There is a growing interest in medically underwritten annuities where information on the members is collected to give the insurer better data which tends to lead to cheaper annuity rates.

A more recent development is a 'synthetic' buy in which makes use of a combination of interest rate inflation and longevity swaps. This is more complex but has the advantage that it does not require a transfer of assets to the insurer.

The Risk/Reward Trade-off

Under both buy in and buy out arrangements all the financial and longevity risks are passed to the insurer. In return the insurer charges a premium that is payable, normally, immediately. There are cases where some of the premium has been deferred for a number of years, but this is an exception rather than the norm.

Buy in/Buy out Suitability

The choice between buying out or buying in the liabilities is complicated. Under the buy in approach, as the bought in members continue to be members, the scheme will still be responsible for ensuring that all necessary disclosure requirements (see Part 2) are met for those members and will still be responsible for the actual payment of benefits. As the scheme is simply insuring its liability for these benefits, however, the purchase of a buy in is simply an investment decision for the trustees and does not require the extensive member communication exercise that is needed before benefits are bought out.

However, given this requirement for payment of the insurer's premium up front, it can be very restrictive on the number of companies that can consider this a viable option i.e., the cost of this certainty can be high.

6.8.4 Trustee Considerations

The amount of active risk taken will vary significantly from scheme to scheme, reflecting differences in their liability profiles, funding positions, appetite for risk and the strength of the sponsoring company. Trustees need to consider all these factors when determining the level of risk, they can or need to take to ensure any shortfall in funding is met. Indeed, contrary to the traditional approach of favouring equities for their high return potential, returns above a certain level may not add sufficient value to justify the additional risk involved.

6.9 ASSET ALLOCATION

6.9.1 Strategic Asset Allocation

Strategic asset allocation refers to the suitability of different asset types, such as equities, bonds, property and cash, to meet a pension scheme's liabilities in the long term. Historically, UK pension schemes have skewed their asset allocation towards equities (with average weightings of 60-70%, having often been as high as 80-90% in the 1980s and 1990s). Although equities offer higher returns than other asset classes over a long time period, the asset class also has a higher volatility of returns and is not well correlated with a pension scheme's liabilities, particularly as a scheme becomes more mature. The risks associated with high weightings of equities in pension schemes was highlighted during the prolonged period of heavy falls in equity markets between 2000 and 2003 and repeated again between 2007 and 2009, which was accompanied by lower interest rates and had a disastrous impact on funding levels.

Changes in regulation have aimed to address the lack of focus on a scheme's liabilities when making decisions on strategic asset allocation. In addition, more responsibility has been put on pension scheme trustees to ensure that they have sufficient knowledge and understanding to make the relevant decisions.

The policy regarding strategic asset allocation decisions has to be laid out by the trustees of a pension scheme in its Statement of Investment Principles (SIP). The trustees are required to consult with the employer on the SIP although, as noted in Part 4, Chapter 6.3, agreement is not necessary it is usually sought.

6.9.2 Tactical Asset Allocation

Tactical asset allocation refers to the day-to-day management of the portfolio's asset mix, which is usually delegated from the trustees to one or more investment managers. Tactical decisions can be made to deviate from a portfolio's strategic or long-term asset mix to take advantage of short-term investment opportunities, based on economic or market developments. Changes in economic conditions can lead to a short-term underperformance or out performance of one asset class over the other or of a certain sector within an asset class over other sectors. Active fund managers can take advantage of these developments by making changes to the portfolio's asset mix, by increasing or reducing the holdings in a particular asset class. Once the economic or market developments have taken their course, the fund manager can return the portfolio's asset mix to the long-term position.

Trustees can provide instructions regarding the implementation of the asset allocation for the investment managers in an Investment Management Agreement which sets out the objectives, guidelines and restrictions within which a fund manager must operate. The Investment Management Agreement will usually specify ranges around the benchmark allocation for each asset class and risk and return parameters for the assets. The manager is then able to make tactical asset allocation decisions around the benchmark within this range. This is one area where the law allows trustees to delegate their responsibility to make decisions. They must however ensure that the managers are suitable to carry out the investment business of the scheme on their behalf.

The investment managers chosen must be authorised to carry on investment business under the Financial Services and Markets Act (FSMA) 2000. If a group of trustees wished to make their own day to day investment decisions, they too would need authorisation under FSMA 2000.

6.10 RISK MANAGEMENT

Risk analysis raises the issue of how much investment risk to take and where to take it in order to reach the desired funding outcome and to ensure that at least the critical funding level is always achieved. Pension schemes have traditionally skewed their asset allocation towards equities in search of higher returns.

A risk management framework should be holistic in nature and not focused on any one area of risk. The interdependence of investment risk, covenant risk and scheme funding is clear and trustees should consider these risks collectively. This is emphasised by the Pensions Regulator in its code of practice. Strategic risk reporting is designed to measure key metrics which influence the main decisions trustees have to make and the success or otherwise against their objectives.

Examples of key risks considered which would be captured in regular reporting would include:

- attribution of total level of risk between interest rate and inflation risk associated with the liabilities, growth asset risk (e.g., equities), active management risk, longevity
- funding level monitoring and its progression relative to the long-term funding level target
- the amount by which the deficit could grow under a bad outcome over a given period given the level of risk being managed
- strength of employer covenant and any material changes that could affect this
- counterparty risk (in relation to any derivative exposures)
- performance of assets versus the change in the value of liabilities
- contribution from active management of the assets

The Pensions Schemes Act 2021 requires certain occupational pension schemes to address climate change risks and opportunities. Major new requirements for schemes over £1bn relating to addressing climate change risk. Significant action expected from trustees, including monitoring climate metrics quarterly and carrying out climate scenario analysis annually – liaison with sponsor CSR teams will often be helpful. Schemes in scope required to publish annual reports setting out how they are managing climate related risks and opportunities to meet the climate change governance requirements that underpin the 11 recommendations of the Taskforce on Climate-related Financial Disclosures – these public disclosures may also increase reputation risk.

The Act will allow Parliament to make regulations requiring trustees to ensure effective pension scheme governance is in place in relation to the effects of climate change.

The Paris alignment regulations come into force from 1 October 2022, will require trustees to obtain and use data to calculate their selected portfolio alignment metric "as far as they are able", and aim to ensure that more than 80 per cent of UK members will be invested in schemes that are helping to limit climate risk.

6.11 STATEMENT OF INVESTMENT PRINCIPLES

The trustees of most DB schemes must draw up a written Statement of Investment Principles (SIP). The SIP sets out the investment objectives and the guiding principles governing the investment strategy, i.e., how decisions about investments must be made. A SIP is not needed for insured schemes that only hold one investment, the insurance policy.

The SIP must include the trustees' policy on:

- responsibilities for investment decisions: this can include details on the responsibility for strategic and day to day management of the scheme's assets, as well as the responsibility for the monitoring of investment performance
- investment objectives: this can include details on the target funding level and the trustees' stance on risk and return, i.e., how much investment risk to take to generate excess returns and where to take it
- the asset allocation strategy: the kinds of investments to be held and the balance between the different kinds of investment
- investment mandates: this includes details on the nature of the contract between the trustees and their advisers/investment managers
- risk management and measurement: risk management processes and how risk is measured
- fee structure
- socially responsible investment: the extent to which the trustees take into account social, environmental or ethical considerations in a scheme's investment strategy
- the trustee's policy towards corporate governance including the approach to exercising the rights (including voting) that are attached to the scheme's investments
- the expected return on assets and the realisation on investments
- how they are complying with legislation, in particular Section 36 of the Pensions Act 1995
- Before the SIP is drawn up, the trustees must:
- obtain and consider the written advice of a person who they reasonably believe to have the appropriate knowledge and experience of financial matters and investment management
- consult with the employer. This means considering the employer's views carefully, but does not require the employer's explicit agreement

The Pensions Act 2004 requires that the SIP should be reviewed at least once every three years and whenever there has been a significant change in investment policy.

If trustees fail to comply with the requirements, they may be prohibited to act as trustees or may face civil penalties.

6.12 MYNERS INVESTMENT PRINCIPLES

In the 2000 Budget, the Government commissioned a review to consider whether there were factors distorting the investment decision making of institutions. Paul Myners was invited to lead the review. He concluded that many pension trustees lacked the necessary investment expertise to act as strong and discerning customers of investment consultants and fund managers. The report, published in March 2001, recommended a voluntary code of practice for pension fund trustees. This initial report was updated in both 2004 and 2008 to give the current principles.

The Myners principles are as follows:

- Effective decision-making – trustees should ensure that decisions are taken by persons or organisations with the skills, knowledge, advice and resources necessary to take them effectively and monitor their implementation. Trustees should have sufficient expertise to be able to evaluate and challenge the advice they receive, and manage conflicts of interest
- Clear objectives - trustees should set out an overall investment objective(s) for the fund that takes account of the scheme's liabilities, the strength of the sponsor covenant as well as the attitude to risk of both the trustees and the scheme sponsor, and clearly communicate these to advisers and investment managers
- Risk and liabilities - in setting and reviewing their investment strategy, trustees should take account of the form and structure of the liabilities. These include the strength of the sponsor covenant, the risk of sponsor default, the maturity, duration and interest rate and inflation sensitivities of the liabilities and longevity risk
- Performance assessment - trustees should arrange for the formal measurement of the performance of the investments, investment managers and advisers. Trustees should also periodically make a formal policy assessment of their own effectiveness as a decision-making body and report on this to scheme members
- Responsible ownership - trustees should adopt, or ensure that their investment managers adopt, the Stewardship Code on the responsibilities of shareholders and agents. A statement of the scheme's policy on responsible ownership should be included in the SIP. Trustees should report periodically to members on the discharge of such responsibilities
- Transparency and reporting - trustees should act in a transparent manner, communicating with stakeholders on issues relating to their management of investment, its governance and risks, including performance against stated objectives. Trustees should provide regular communication to members in the form they consider most appropriate

Summary

For DB schemes, the investment strategy aims to ensure that a scheme's assets are sufficient to cover its pension liabilities. The choice of investment strategy (i.e., asset mix) is the responsibility of the trustees and is arguably the biggest decision that will determine whether they achieve the objectives of the pension scheme. Trustees of DB schemes need to know how much money a fund should contain today in order to fulfil the pension promises to its members when they retire. A detailed analysis of liabilities is required.

Any losses accrued in a company's pension scheme are reflected in the sponsoring company's balance sheet. Trustees therefore need to take into account the employer's attitude to risk.

The decision on the investment strategy employed depends on the size of the scheme, the current funding level and the strength of the employer covenant.

Some of the approaches a DB scheme can take are liability driven investment (LDI), longevity swaps and buy ins/buy outs. LDI is a structured approach to relating the assets to the liabilities. In this strategy, a core portfolio is designed to match more precisely the profile of a scheme's liabilities and reduce financial risks. A growth-seeking component can be added to this core portfolio. Longevity swaps are financial instruments designed to reduce the scheme's longevity risk. Buy ins/Buy outs are contracts with insurance companies where they pay the pension amounts and all financial and longevity risk is transferred to them. Trustees must outline a scheme's strategic asset allocation policy, which refers to the suitability of different asset types, such as equities, bonds, property, cash, hedge funds, derivatives and alternative asset classes, to meet a pension scheme's liabilities. Tactical asset allocation, which refers to the day-to-day management of the portfolio's asset mix, is usually delegated from the trustees to one or more investment managers.

The trustees must draw up a written Statement of Investment Principles, which sets out the principles governing the investment strategy.

The Myners Review found that many pension trustees lacked the necessary investment expertise to act as strong and discerning customers of investment consultants and fund managers. The review set out a number of voluntary principles that trustees should follow regarding a scheme's investment strategy.

Self Test Questions

- What does the strength of the employer's covenant refer to?
- Describe the key components of a liability driven investment.
- Explain the difference between strategic and tactical asset allocation.
- Analyse the advantages and disadvantages of a longevity hedge versus a buy in.
- Distinguish between a buy in and a buy- out policy.

Part 5

WINDING UP AND THE PENSION PROTECTION FUND

OVERVIEW

So far in this study manual we have looked at the issues relevant to a DB scheme that is continuing in existence, including how the design of the scheme may be changed, how it is administered on a day-today basis, the tax and governance regimes that apply to it and how the benefits are funded.

There may come a time, however, where the scheme is discontinued or 'wound up'. This can arise for a number of reasons. For example, the employer may wish to replace the scheme with a different scheme or may no longer feel able to support the scheme on an ongoing basis, or the employer may become insolvent and will no longer exist to support the scheme.

This Part looks at the various processes involved in winding up a scheme. Chapter 1 is concerned with the winding up of a scheme where the employer is solvent, where benefits for members will need to be secured with an insurance company or by means of a transfer to another scheme. Chapter 2 looks at what happens where the sponsoring employer is insolvent and has an underfunded DB scheme. In these cases, the scheme may be eligible to enter the Pension Protection Fund (PPF) with members' benefits being paid by the PPF in the form of compensation, and a detailed assessment process must be gone through before a scheme can transfer to the PPF.

The processes involved in winding up a scheme and/or preparing for transfer to the PPF can be lengthy and time-consuming. It is nonetheless critical that these processes are followed very carefully to ensure all members receive their correct benefits, because once the scheme has completed winding up there will be no further assets available to meet any subsequent claims.

After studying this Part, you should have a good understanding of how a scheme winds up and/or prepares, where appropriate, for entry to the PPF. In turn, this will complete your study of the life cycle of a DB scheme.

CHAPTER 1

Winding Up

INTRODUCTION

The winding up of a DB scheme is usually a lengthy process, which can often take a number of years to complete.

This chapter looks at the various stages in a winding up where the sponsoring employer is still solvent. It starts off by looking at the events which may trigger a winding up and then moves on to look at the process for carrying out the winding up. It then touches on aspects which may arise where the sponsoring employer is insolvent, including the possible involvement of the Pension Protection Fund – a subject which is covered in detail in the next chapter. It also looks at the special considerations which arise where a scheme was contracted out before 6 April 2016 and where the scheme's investments include insurance policies.

It is important that trustees take great care when dealing with a scheme wind up, as if claims to benefits were to come to light after the wind up had been completed, there would be no assets from which to meet those claims, which could in certain circumstances make the trustees personally liable. There are however a number of ways to avoid such an outcome, which are outlined at the end of the chapter.

By the end of this chapter, you should have a clear understanding of the process involved in winding up a DB scheme of a solvent sponsoring employer.

1.1 BACKGROUND TO WINDING UP

The winding up of a pension scheme is usually a lengthy process, which often takes a number of years to complete. It is important to be clear as to the date upon which winding up commences and to note that this will usually terminate the accrual of benefits for members under the scheme (including the payment of death in service benefits).

The process that a scheme's trustees will need to go through in order to wind up the scheme will depend upon whether or not the scheme is eligible to enter the Pension Protection Fund (PPF). This will depend largely on the status of the scheme's sponsoring employer (whether it is solvent or insolvent) and the funding position of the scheme. Where a scheme is not eligible to be transferred into the PPF, members' benefits will need to be secured with an insurance company in accordance with the relevant priority order (see Part 5, Chapter 1.3.2).

Note that, if a scheme is in deficit on a buy- out basis when it commences winding up, a section 75 debt will become due from the employer(s) to the trustees equal to the amount of that deficit, so it is possible that some or all of any deficit will be recovered.

There are two main situations in which an occupational pension scheme will terminate:

- on the occurrence of one of the circumstances specified in the scheme's Trust Deed for the commencement of winding up, or
- at the direction of the Pensions Regulator

1.1.1 Circumstances Specified in the Trust Deed

A scheme's Trust Deed will invariably list a number of circumstances in which the winding up of a scheme will be triggered. The most common are:

- the principal employer giving notice that it intends to cease contributing to the scheme
- the principal employer ceasing to trade or becoming insolvent
- when there are no beneficiaries left to benefit from the scheme, or
- where the trustees have received advice from the scheme actuary that the employer will be unable to fully fund the scheme

There may also be circumstances in which only part of the scheme will be wound up (e.g., where one employer leaves a multi-employer scheme the trustees may be required to secure the benefits of the members associated with that employer). Where a partial wind up occurs, the part of the scheme relating to the relevant employer is wound up whilst the rest of the scheme continues.

In some circumstances the commencement of a scheme wind up may be automatic, whereas in other circumstances it may be at the discretion of the trustees. This will depend on the scheme's rules.

1.1.2 Termination by the Pensions Regulator

The Pensions Regulator has powers under section 11 of the Pensions Act 1995 to direct or authorise that a scheme be wound up (regardless of the provisions of the scheme's Trust Deed) where:

- the scheme, or part of it, ought to be replaced by another scheme
- the scheme is no longer required, or
- it is necessary to protect the interests of the generality of the members

The regulator is unlikely to order a winding up without a compelling case being made to it.

1.1.3 Postponement of Winding Up

The mere fact that a winding up has been triggered under the scheme's rules does not necessarily mean that the scheme will have to be wound up. Many schemes contain a provision in their Trust Deed to allow the trustees to postpone the winding up and to continue to run the scheme. Section 38 of the Pensions Act 1995 allows trustees in certain cases to defer winding up and to run the scheme on as a closed scheme, where there is no such power in the rules.

1.2 CLOSING A SCHEME

As a precursor to winding up it is common for a scheme to be closed to new members and to future accrual for existing members.

Where a scheme is closed to new members it means that, whilst there will be no new joiners, the existing active members will continue to accrue benefits. Where a scheme is closed to future accrual (sometimes referred to as "frozen") the scheme continues to exist (i.e., it is not wound up) but no further benefit accrual takes place, and no new members are admitted. Where a scheme is closed to future accrual the members' benefits would normally be calculated by reference to their salary at the date on which the scheme was closed. However, under some schemes, the active members may be entitled to retain the right to have their benefits calculated by reference to their salary when they leave employment, die or retire (and not when the scheme is closed). This is an important issue, which must be checked before a scheme is closed to future accrual.

It is usual for an employer to initiate the closure of a scheme and this practice has become increasingly common for employers with DB schemes, out of a desire to avoid the risk and costs associated with continuing to run such schemes. An important issue for an employer to consider on the closure of a scheme to new members is what pension arrangements it will offer to its new employees and the potential industrial relations problems that may arise from providing different arrangements to different members of its workforce (who may be doing the same job). It is also necessary to consider whether this may also give rise to any age discrimination issues, as the age profile of the members in the DB scheme will continue to increase, with the result that older employees may be receiving a better benefit than younger employees. It is also important to note that even where an occupational pension scheme is closed to future accrual, the employer will still be required to fund members' accrued benefits.

The formalities for the closure of a scheme can be subject to debate. It would usually be achieved either by the employer exercising an express power in the Trust Deed and Rules or by the exercise of the power of amendment to alter the eligibility provisions to exclude new and (where relevant) existing members. It may also be achieved, in certain circumstances, by changing the terms and conditions of employment of the members.

The closure of a scheme to new members or to future accrual will not normally trigger the winding up of the scheme. However, the provisions of each scheme's Trust Deed and Rules should be carefully checked before this takes place.

The Pensions Regulator also has the power to close a scheme to future accrual under section 231 of the Pensions Act 2004, where the trustees and the employer fail to comply with the statutory funding requirements.

1.3 PROCEDURE FOR WINDING UP

1.3.1 Trustees' Position

When a scheme wind up is triggered, the Trust Deed will invariably require the trustees to notify the members of the winding up. In any event, the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 require trustees to inform members within one month of the commencement of winding up. At the outset of the winding up process trustees should also put in place a project plan.

The trustees' powers will generally continue to be exercisable following the commencement of wind up, although a scheme's Trust Deed may vary this position. For example, it may provide that the power of amendment cannot be exercised following the commencement of wind up or that the employer's consent is no longer required to amendments or that only the powers contained in the winding up provisions are available. Where this is the case, it can cause significant practical problems. If the winding up is planned (i.e., it is triggered at the employer's or the trustees' initiative) it may be possible to amend the scheme rules before winding up is triggered so that these powers continue after winding up has started.

During the wind-up process, the trustees must realise the scheme's assets and commission an actuarial valuation (although if the wind up commenced after 29 December 2005, annual estimates of the solvency of the scheme from the actuary will suffice). Where the scheme does not have sufficient assets to secure members' benefits in full the trustees must apply the scheme's assets (after the payment of expenses) in accordance with the relevant priority order. It is very common for trust deeds and rules to contain a priority order. However, the priority order in section 73 of the Pensions Act 1995 will override the scheme priority order where the winding up commenced on or after 6 April 1997 (see Part 5, Chapter 1.3.2).

Towards the end of the winding up process the trustees must either secure members' benefits by purchasing annuities in the members' names from an insurer or transfer members' benefits into another scheme. Finally, the scheme should be brought to an end by way of a deed of termination.

1.3.2 Priorities

Where wind up commenced on or after 6 April 1997, the priority order in the Trust Deed and Rules is overridden by the statutory priority order which is set out in section 73 of the Pensions Act 1995.The statutory priority order has itself been amended on a number of occasions since 1997 and the statutory priority order which will apply to the scheme will depend on the date the winding up was triggered. The current statutory priority order applies to wind ups which commence on or after 6 April 2005.

These priorities are set principally by reference to the level of benefits which would be provided by the PPF (see Part 5, Chapter 2) to ensure that liabilities which would otherwise fall to be met, wholly or partly, out of the PPF are met out of the scheme where possible. The order will therefore be as follows:

- first, payment of scheme expenses, if the scheme rules provide for these to be the first priority
- second, benefits under insurance policies issued before 6 April 1997 which may not be surrendered
- third, any liability for pensions or other benefits that does not exceed the corresponding PPF liability (except where covered under the second priority, above)
- fourth, any liability for pensions or other benefits derived from members' voluntary contributions (where these provide a defined benefit such as added years of pensionable service), and
- fifth, any other liability for pensions or other benefits

The corresponding PPF liability means the cost of securing the benefits which would otherwise be paid by the PPF.

After the scheme's assets have been applied to secure members' benefits in full, most schemes' trust deeds will direct that any remaining surplus will be applied, at the discretion of the trustees, to increase the benefits of some or all of the scheme's beneficiaries or that it should be returned to the sponsoring employer.

HMRC will impose tax charges on the beneficiary and the scheme, if the benefits provided on the winding up of a scheme are not provided by means of recognised transfer payments to a new scheme, or "authorised payments" to the member by way of lump sum (where permitted by the tax rules) or purchase of an annuity. There is also a penalty of £3,000 per member if HMRC considers that the whole or main purpose of the winding up is to facilitate the payment of winding up lump sums to members.

1.3.3 Award of Benefits

On a winding up members will either take a transfer of their benefits to another registered pension scheme which they are eligible to join, and which is willing to receive the transfer payment, or they will have an annuity/deferred annuity purchased in their name. A lump sum may only be paid where the member has trivial benefits or has less than two years' service.

Where benefits are secured by the purchase of an annuity policy, the policy must provide those benefits are in the form of a pension (except to the extent that a lump sum is permitted). In addition, the terms of the policy must not permit benefits to be paid before the earliest date from which an immediate pension on early retirement could be paid under the rules of the scheme, unless the employee suffers serious ill health. The terms of the contract or policy will also need to provide for authorised payments only, in order to avoid any additional tax charges under the Finance Act 2004.

1.3.4 Modification by the Pensions Regulator

Under Section 71A of the Pensions Act 1995, the Pensions Regulator has power to make an order to modify a scheme which is being wound up where the employer is subject to an insolvency procedure, in order to ensure that it is properly wound up. The regulator can only exercise this power if an application for the order is made by the trustees or managers of the scheme. Any order must be limited to the minimum required in the circumstances and must not have an adverse effect on the accrued rights of scheme members or any entitlement to receive benefits.

1.3.5 Supervision by the Pensions Regulator

Sections 72A to 72C of the Pensions Act 1995 enable the regulator to supervise and ensure the speedy winding up of schemes. These provisions place a duty on the trustees or managers of the scheme which is being wound up to make periodic reports to the regulator as to progress. Where a winding up starts on or after 1 October 2007 the first report must be made to the regulator within three months after the second anniversary of the date on which the winding up commenced. The Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 enable any member of a scheme to be

provided with a copy of a report made to the regulator within two months of the request being made. In its guidance on winding up a pension scheme, the regulator has indicated that it expects most wind ups to be completed within two years.

Under The Pension Schemes Act 2021 the regulator has been granted enhanced inspection and interview powers to support its existing information gathering powers under section 72 of the Pensions Act 2004. It will be easier for the regulator to require anyone connected with the running of a pension scheme, or a scheme employer, to attend for interview. Failure to attend for interview will be a criminal offence carrying a maximum penalty of up to £5,000. The regulator could, instead, issue a fixed penalty notice of up to £50,000 or an escalating penalty notice with a daily rate of up to £10,000.

Another regulation incorporated into this Act was the provision of Information to the regulator. A new section 80A, inserted into the Pensions Act 2004, gives the regulator power to issue fines of up to £1 million to a person who has knowingly or recklessly provided information to the regulator that is false or misleading where the information is provided in certain specified circumstances, including the pension scheme return and notifiable events regime. The fine will also be available where the person providing the information intends, or could be reasonably expected to know, that the regulator would use the information for the purpose of carrying out its functions.

Provision of Information to Pension Trustees.

Likewise, a new section 80B,was inserted into the Pensions Act 2004 by the Pension Schemes Act 2021, giving the regulator power to issue fines of up to £1 million to a person who has knowingly or recklessly provided information that is false or misleading to the trustees of a DB pension scheme in various specified circumstances with a catch-all that the fine will also be available to TPR where the person intends, or could be reasonably expected to know, that the information would be used by the trustees in their capacity as trustees.

1.3.6 Written Records

Under section 49A of the Pensions Act 1995, the trustees or managers of a scheme are required to keep written records of any determination that the scheme is to be wound up in accordance with its rules, decisions as to the time from which steps for the purposes of the winding up of the scheme are to be taken, determinations under section 38 of the Pensions Act 1995 to defer a winding up and determinations in accordance with the rules of the scheme to postpone the commencement of winding up.

1.3.7 Directions by the Pensions Regulator

Section 72B of the Pensions Act 1995 allows the Pensions Regulator to give directions to facilitate the winding up of a scheme on the grounds that:

- the trustees or managers are not taking all the steps that the regulator considers would be taken if they were acting reasonably
- steps are being taken by the trustees or managers that the regulator considers to be causing unreasonable delay
- the winding up is being obstructed or unreasonably delayed by the failure of any person to provide information to the trustees or administrator or to take any step that he has been asked to take by them, or
- the winding up is likely to be facilitated or accelerated by the taking of any step by any person other than the trustees or managers

The regulator can give directions where periodic reports are being made under section 72B of the Pensions Act 1995 and the first report has either been made or should have been made.

The regulator can require the trustees, or any person involved in the administration of a scheme (apart from the employer, the scheme auditor, the scheme's legal adviser or any fund manager) to:

- provide the trustees or managers with specified information
- provide persons involved in the administration with specified information
- provide any prescribed person with information, or
- take such steps as may be specified

Penalties can be imposed under section 10 of the Pensions Act 1995 upon any trustee who fails without reasonable excuse to comply with such an order and upon any other person who fails to comply with a direction.

The regulator also has the power to appoint an independent trustee where there is an insolvency event in relation to an occupational pension scheme and it keeps a register of independent trustees for this purpose.

1.3.8 Scheme Surplus

Any surplus remaining after all benefits have been secured in full must be dealt with in accordance with the terms of the Trust Deed, subject to legislation. For example, the trustees may have a discretion to enhance members' benefits, or to return any surplus to the employer(s). Alternatively, the exercise of this power may require the consent of the principal employer.

Where the trustees have the power to decide whether to use surplus to enhance members' benefits or to pay a refund to the employer(s) (or, in many cases, the liquidator for the benefit of the employer's creditors) the decision is a difficult one. In any event, section 76 of the Pensions Act 1995, which overrides the rules, provides that, where there is a power for surplus to be returned to the employer, it must not be exercised unless:

- all benefits have been bought out in full
- if there is a power to augment benefits, that power has been exercised or a decision has been taken not to do so, and
- two notices have been given to members, the first stating they may make representations to the trustees or employer and the second stating that they have the right to make representations to the Pensions Regulator if they think the refund requirements are not satisfied. The notices must allow a five month period in total for representations to be made

A tax charge is levied on any refund to the employer. The scheme administrator is required to pay 35% of the amount of the refund directly to HMRC.

1.4 EMPLOYER INSOLVENCY

1.4.1 Protection of Assets from Creditors

Where a scheme is wound up as a result of the principal employer's insolvency, the pension scheme's status as a trust means that the assets of the scheme are held separately from those of the employer. Therefore, they are protected against claims from the employer's creditors even if the employer is the sole scheme trustee.

Trust status will not, however, protect the value of any scheme assets which are invested in the employer's business (although for most schemes these are in any event limited by law to no more than 5% of the scheme's assets).

1.4.2 Arrears of Contributions

Section 124 of the Pension Schemes Act 1993 provides limited safeguards for occupational pension schemes in the event of the insolvency of an employer. The trustees or administrators of such schemes may apply to the Secretary of State for Work and Pensions for payment from the State redundancy fund in respect of relevant contributions which were due, but unpaid, by the insolvent employer.

Relevant contributions are principally those due in the 12 months prior to the date of the insolvency subject, in the case of an employer's contributions, to a maximum amount equal to 10% of remuneration paid, or payable, to the members during that period.

1.4.3 The Pension Protection Fund and the Financial Assistance Scheme

Where a scheme's sponsoring employer has become insolvent it may be eligible to enter the Pension Protection Fund (PPF). The PPF was established under the Pensions Act 2004 and applies, broadly, to the schemes of companies that become insolvent from 6 April 2005.The PPF is designed to provide compensation to members of DB schemes of an insolvent employer where the scheme is underfunded on the PPF basis.

Under Section 286 of the Pensions Act 2004, the Secretary of State for Work and Pensions was given powers to establish the Financial Assistance Scheme (FAS) to provide benefits for certain members of pension schemes, which are not money purchase schemes, and which do not qualify for the PPF.

Part 5, Chapter 2 gives more information on the PPF and the FAS.

1.5 TERMINATION OF CONTRACTING OUT

The new State pension was introduced from 6 April 2016 and all contracting out ceased from that date. If contracting out terminated on 6 April 2016 as a result of abolition of contracting out, no notification of termination of contracting out was required to be made to HMRC, nor is HMRC approval required to the securing of contracted out rights.

Where contracting out ceased before 6 April 2016, HMRC had to be notified of the termination and approval sought from HMRC for any proposed arrangements for securing the contracted-out rights. Such rights will include GMPs accrued up to 5 April 1997 or reference scheme rights in respect of post 5 April 1997 service or a combination of both. Rights may be secured by:

- a transfer to another scheme which was contracted out before 6 April 2016
- the purchase of a policy (known as a section 32 buyout policy) from an insurer, or
- the purchase of an immediate or deferred annuity from an insurer

The Government has stated that GMPs need to be equalised between men and women. GMPs for men and women are unequal because their value to a male and female scheme member of identical age, pensionable service and pensionable salary is different. This is because GMP comes into payment at age 60 for females and 65 for males, and also because of differences in pension increases.

During 2012 the Government consulted on possible methods of GMP equalisation. Its interim response announced that it would not proceed with the unpopular non-mandatory methodology which it had proposed, but that it had not changed its view that GMPs must be equalised (many legal practitioners disagree). It would therefore be laying regulations in due course.

Subsequently, a working group consisting of representatives from the pensions industry and the Department for Work and Pensions (DWP) has been developing a methodology for equalising for the effects of GMP using GMP conversion. The Government consulted on various aspects relating to the methodology in November 2016.

GMP equalisation is relevant to ongoing schemes but is particularly acute, however, in relation to schemes which are being wound up. If equalisation is ignored claims could potentially be made against trustees after the winding up has been completed and the trustees might be found to be personally liable.

1.6 DISCONTINUANCE OF INSURANCE POLICIES

On the termination of a scheme, there are usually two options available in relation to insurance policies held as assets of the scheme:

- to take a surrender value and use the proceeds elsewhere, or
- to treat the benefits as paid up so that no further premiums are payable, and the policy can then be assigned to the relevant member

Where both options are available it is a question of deciding which is the more beneficial in the circumstances.

A surrender value is normally calculated by the insurance company as and when required, but the policy may contain a guaranteed minimum surrender value basis. The surrender value quoted will usually hold good for a relatively short, stated period. If the surrender value is large the insurer may require advance notification of the intention to surrender. Alternatively, it may reserve the right to pay the surrender value over a period of time. An insurance company is in business to sell annuities or investment policies and not to buy them back again. The premiums charged and other terms of the policy reflect this. An option to surrender on guaranteed terms at any time would leave the insurance company open to adverse 'selection' by the policyholder.

The surrender of a policy means that the insurance company will not receive all the premiums it anticipated and will not therefore, under certain types of policies, recoup all the expenses (including commission paid to brokers) it would otherwise have done. Also, to pay the surrender value the insurance company may have to realise the underlying investments (made on a long-term basis) at an unfavourable time. In calculating the surrender value, the company usually therefore imposes a penalty or market value adjustment on the policyholder to protect itself. The surrender value offered will invariably be less than the accumulated premiums paid and investment growth to date.

The method of exercising the alternative option of taking paid up benefits depends upon the form of the insurance policy.

It should be noted that, apart from one or two exceptions, an insurance policy is like any other contract. If an insurance company wishes to impose terms and conditions these must be reflected in the terms of the policy when it is issued.

1.7 PRACTICAL POINTS

The winding up of a pension scheme will be completed, and the scheme can be terminated by means of a deed of termination, when it has no assets. For the trustees, this is the point of no return since, if any claims arise afterwards, there will be no assets available to the trustees either to meet the liabilities or to defend any challenge. The trustees may therefore be personally liable in respect of valid claims.

There are a number of mechanisms for avoiding this outcome:

- Section 74 of the Pensions Act 1995 provides for trustees to be discharged if the benefits are dealt with in accordance with that section
- a Section 27 of the Trustee Act 1925 notice to identify missing beneficiaries. The section requires a notice to be published in the London Gazette and in one other newspaper and to give missing beneficiaries a period of two months to notify claims to the trustees. If no claims are received, the trustees can use the scheme assets for the benefits of members of whom they are aware. The trustees would not be liable in respect of any claims from unknown beneficiaries that are made after the notice period has ended although there is debate as to the effectiveness of such notices
- many trust deeds provide trustees with an exoneration clause under which they are free from obligations to members other than those which arise out of wilful neglect or default
- many schemes include an indemnity from the principal employer to the trustees in respect of claims arising otherwise than out of dishonesty. Such an indemnity will, however, only be of value if the employer remains solvent
- the trustees may take out 'run-off' insurance to protect them from claims and the cost of defending these, for a period after the winding up has been completed. The premium for such cover can only be taken from the funds of the scheme if the Trust Deed permits this. Otherwise, the premium would have to be met by the employer or by the trustees personally

On winding up, the trustees must complete an Event Report online for HMRC.

Summary

Winding up is usually triggered by an event specified in the Trust Deed. It can also be triggered by the Pensions Regulator in certain circumstances.

Where a scheme is closed to new members it means that, whilst there will be no new joiners, the existing active members will continue to accrue benefits.

Where a scheme is closed to future accrual the scheme continues to exist, but no further benefit accrual takes place, and no new members are admitted.

Where a DB scheme is in deficit but is ineligible to enter the PPF, the statutory winding up priority order in Section 73 of the Pensions Act 1995 will determine the order in which scheme assets are to be applied.

Securing members' benefits will usually require the trustees to purchase an annuity from an insurance company.

Surpluses must be dealt with in accordance with a scheme's Trust Deed and legislation.

The PPF (and, to a limited extent, the FAS) have been established to protect members of schemes in deficit whose employers have become insolvent.

There are detailed requirements for terminating contracted out employment before 6 April 2016 and for terminating insurance policies.

Self Test Questions

- Outline the circumstances in which a pension scheme is likely to commence winding up.
- Distinguish between the closure of a scheme to new members and the closure of a scheme to future accrual.
- Explain in what order of priority the scheme's assets are to be used to secure members' benefits, where a DB scheme commences wind up after 5 April 2005.
- Outline the steps which must be taken before a refund of surplus can be made to the employer.
- Describe the practical steps that trustees can take to protect themselves against claims arising after their scheme has been wound up.

CHAPTER 2

The Pension Protection Fund and the Financial Assistance Scheme

INTRODUCTION

This chapter looks at how the Pension Protection Fund (PPF) becomes involved in the winding up of an underfunded DB scheme whose sponsoring employer is insolvent.

In particular it looks at the various steps and processes during the PPF assessment period, which schemes need to go through before they can enter the PPF, and the importance of ensuring that scheme membership data and records are reviewed for accuracy. It also looks at the various levies which DB schemes have to pay, which go towards the cost of paying the benefits from the PPF (known as 'compensation').

After studying this chapter, you should have an understanding of the importance of the PPF assessment period and the various actions which must take place during this period before a scheme can enter the PPF, and how the PPF levy is calculated.

2.1 ROLE OF THE PPF

The PPF is a statutory body which was established under the Pensions Act 2004 and became effective from April 2005.The PPF is designed to provide compensation to members of DB schemes of an insolvent employer where the scheme is underfunded on the PPF basis.

The PPF is also responsible for the Fraud Compensation Fund - a fund that will provide compensation to occupational pension schemes that suffer a loss that can be attributable to dishonesty.

2.2 INSOLVENCY EVENT

In most instances, before a scheme can enter the PPF, the sponsoring employer must have suffered a 'qualifying insolvency event'. A qualifying insolvency event occurs in relation to an employer where:

- a proposal for a voluntary arrangement is made by the employer
- there is an application for a moratorium where a voluntary arrangement is proposed
- an administrative receiver is appointed
- the company enters into administration
- the company enters into a voluntary wind up without a declaration of solvency
- a members' voluntary liquidation is converted into a creditors' voluntary liquidation
- a winding up order is made by a court

A members' voluntary liquidation is not an insolvency event for this purpose, because a requirement of a members' voluntary liquidation is that the company should be able to pay all its debts in full.

Following the occurrence of an insolvency event in relation to an employer the insolvency practitioner must give notice, under section 122 of the Pensions Act 2004, to the PPF, the Pensions Regulator and the trustees of the scheme. The insolvency practitioner must also issue a notice to confirm either that a scheme rescue is not possible or that a scheme rescue has occurred. These notices are known as a scheme failure notice and a withdrawal notice respectively.

When a company is subject to a qualifying insolvency event the insolvency practitioner or official receiver must also issue a Section 120 notice within 14 days of the insolvency event or becoming aware of the pension scheme. The PPF must determine if the scheme is eligible for entry into an assessment period (see Part 5, Chapter 2.3) within 28 days of receipt of the Section 120 notice. This is called the validation period.

The PPF will assess whether the insolvency event was a qualifying event and that the scheme is eligible for assessment.

If the scheme is not validated to enter an assessment period there is no further involvement by the PPF, however if the scheme is validated then it enters an assessment period.

The Pension Schemes Act 2021 introduces two new grounds on which the regulator can issue a contribution notice in relation to a defined benefit pension scheme. These are where the "employer insolvency test" or the "employer resources test" is met. These new tests sit alongside the existing material detriment test. The employer insolvency test will be met if the regulator is of the opinion of both of the following: Immediately after an event occurred, the value of a scheme's assets is less than the value of its liabilities and If a section 75 debt had fallen due from the employer immediately after the event, the act or failure to act would have materially reduced the amount of the debt likely to be recovered by the scheme. For the purposes of this test, the value of a scheme's assets and liabilities and the estimated amount of any section 75 debt (had one fallen due) will be whatever the regulator estimates them to be.

The employer resources test will be met if the regulator is of the opinion that an act or failure to act reduced the value of resources of the employer and the reduction was a material reduction relative to the estimated section 75 debt in the scheme if a debt had fallen due immediately before the act or failure to act occurred. As is the case with the employer insolvency test, the value of a scheme's assets and liabilities and the amount of any estimated section 75 debt (had one fallen due) will be whatever the regulator estimates them to be. What constitutes an employer's resources, and the value of those resources, will be set out in regulations.

There are new Penalties for Failing to Comply with a Contribution Notice Failure to comply with a contribution notice is now a criminal offence, carrying an unlimited fine. Alternatively, the regulator will be able to levy a civil fine up to a maximum amount of £1 million.

2.3 ASSESSMENT PERIOD AND TRANSITION

2.3.1 Assessment Period

All validated schemes go through an assessment period before entering the PPF. The aim is to complete assessment for most schemes within two years.

The parties involved in an assessment period include the following:

- Insolvency practitioner
- Trustees
- PPF case handler
- PPF Specialist Panel Independent Trustee
- PPF Specialist Panel Actuary. This is a joint panel appointment with the Panel Administrator (see below), i.e., the same organisation will usually provide both services
- PPF Specialist Panel Administrator
- PPF Specialist Panel Auditor
- PPF Specialist Legal Adviser
- Scheme Legal Advisers
- Incumbent administrator
- Anyone who can assist the process with historic experience of the scheme

During assessment, the trustees need to

- ensure that all the data held for the scheme is accurate. This will ensure that members receive the right compensation payments
- continue paying pensions from the scheme, but at PPF levels of compensation (see Part 5, Chapter 2.5) The key message from the PPF is to ensure that the right benefit is paid to the right member at the right time.

2.3.2 Main Assessment Processes

The main processes which need to be completed during the assessment period are:

Data Audit

When a scheme enters an assessment period one of the key deciding factors affecting how long it will take the scheme to work through all the processes is the quality of the data. Often schemes have been administered for many years with benefits paid correctly and on time, but with the data stored in

many different media or with the administrators having to write to members for details which have been misplaced during a change of administrators.

One of the first tasks in the assessment period is to perform a data audit to measure that all the data required to complete all the tasks is available. If there are significant gaps or incorrect data, then the data needs to be cleansed before the other projects can commence.

Most schemes will already have applied the Pensions Regulator's record keeping requirements (see Part 2, Chapter 1.3) to their scheme, i.e., common data issues should have been addressed. Also, the conditional data issues should have been identified and discussed by the trustees. However, these data audit tests take a closer look at the data required to transfer the scheme into the PPF and so the focus needs to be tailored to that purpose.

A number of members of the Specialist Administration & Actuarial Services Panel (SAASP) have developed specific software to analyse the membership data to satisfy the PPF assessment period needs.

Data Cleanse/Personal Details Verification

The data cleansing can be supported by conducting a Personal Details Verification exercise, where the trustees write to all members with details of their membership of the scheme and ask them to confirm that these are correct or to provide evidence where any changes need to be made.

Member Tracing & Pensioner Existence

During the assessment period, it may be found that a number of member addresses are not available or may be incorrect. It is advisable to undertake a tracing exercise to enable all members to be contacted about what is happening with the scheme.

Over recent times, as the subject of pension fraud has been considered more by trustees and their advisers, it is crucial that all those members in receipt of a pension are reviewed to confirm they are still alive. Whereas for an ongoing scheme this may be regarded as something the trustees may wish to consider, under the assessment process this is a task which needs to be completed, particularly for higher risk cases such as pensioners living abroad.

Guaranteed Minimum Pension Reconciliation

An important project of the assessment period is the Guaranteed Minimum Pension (GMP) reconciliation if the scheme was formerly contracted out of the State Second Pension. This is where the contracted-out membership and the GMP amounts held by the administrator are compared with those held by HMRC and any differences are investigated until all the details have been agreed subject to certain tolerances. This can be a lengthy process depending on the number of discrepancies between the data sets, the response times from HMRC and the complexity of any scheme history.

Once the reconciliation has been accepted by HMRC a Section 50 notice is issued to the trustees (if the scheme ceased to be contracted out before 6 April 2016) and any appropriate amendments to the benefits are made.

Benefit Audit

To check that the benefits of the scheme have been calculated in line with the Trust Deed and Rules throughout the full history of the scheme, a benefit audit needs to be carried out. A matrix containing a sample, usually 10%, of members from all sections of the scheme is agreed with the trustees. An audit of how these benefits should have been calculated is undertaken from first principles and these results are compared to what has been calculated by the administrators and paid out to pensioners.

Benefit Rectification

Where differences have been identified from the benefit audit, GMP reconciliation, scheme equalisation or GMP equalisation exercises and correction is needed, the trustees will request that these benefits and others of a similar nature are rectified to the correct level and any overpayments and underpayments are corrected.

If the sample audited raises various inconsistencies with no clear pattern, then the sample can be increased until the trustees are satisfied that subject to a few random errors, the benefits have been calculated correctly.

Alternatively, if it appears that there are systematic errors for sections of the scheme, then the benefits of all members may have to be recalculated and rectified to the correct level. Any overpayment or underpayment needs to be identified and the trustees will decide on a course of action for resolving these. Where any differences in the level of benefits have occurred these need to be considered in line with administration practices against the Trust Deed and Rules. Historically, if there were times when a scheme was in surplus, the trustees, in conjunction with their advisers and the employer, may have taken the decision to provide benefits in addition to those specified in the Trust Deed and Rules.

Money Purchase Benefit Identification and Discharge

In general, the PPF cannot accept the transfer of any benefit which is deemed to be money purchase. Therefore, all the money purchase benefits contained within the scheme need to be identified and decisions taken on how best to discharge these benefits into the individual members' ownership.

Insured Pension Identification

Where a scheme has benefits secured with an insurer, these need to be identified and cut back to the PPF levels as appropriate. As part of this process the insurers are required to assign the benefits to the PPF and this needs to be established and completed in advance of transfer to the PPF.

Annual Scheme Accounts plus Completion Statements

All schemes entering into a PPF assessment period need to prepare a full set of audited accounts as at close of business on the day before the insolvency event. The accounts should be prepared in accordance with the requirements of FRS 102 and the recommendations of the Statement of Recommended Practice (SORP). The accounts do not need to be accompanied by other disclosures required for the annual report e.g., Trustees' Report, Independent Auditor's Statement about Contributions, Summary of Contributions, Compliance Statement and Actuarial Statements unless they are also being prepared as the scheme's statutory accounts.

2.3.3 Trustees' Duties

During this lengthy process, trustees are responsible for informing their members about all aspects of the assessment process and the progress it is making.

Communication

As soon as a scheme enters a PPF assessment period, an initial announcement is issued by the trustees. This announcement

- explains what has happened to the sponsoring employer
- explains what happens to the scheme now
- advises that certain members will receive about 90% of their expected benefits in the form of compensation
- provides a list of Frequently Asked Questions
- gives details about what happens to those currently receiving a pension and those not currently receiving a pension
- provides contact details on where to request any further information

Trustees also remain responsible for paying pensions throughout the assessment period, but at PPF levels of compensation (see Part 5, Chapter 2.5).

Project Management

In the best interests of the members, the whole assessment and transition process is expected to take between 12 and 24 months (sometimes quicker, sometimes a little longer depending upon circumstances). The key to making sure that all the assessment and transition tasks are completed in an efficient and timely manner is project management. At the start of the assessment period there is a process called 0 to 100 days whereby a quick review is undertaken around the details of the scheme and its membership data. At the end of this 100 days, all the relevant parties get together to:

- formalise the project plan
- set timescales for each project
- agree budgets for each project, and
- assign roles and responsibilities

The project manager will update the project plan and circulate it around all parties at regular intervals to ensure that nothing slips from the plan and if it does, discuss how to get the overall assessment back on track.

The project manager can be the independent trustee, the Specialist Administration & Actuarial Services Panel administrator or anyone else who is deemed suitable for the role.

There are regular meetings, usually via teleconference, to be held, often with the SAASP, trustees and PPF. As well as reporting on the plan and progress with respect to agreed timescales, these meetings are to agree on courses of action following reports provided to all parties.

For example, once the benefit audit has been completed, if it is uncovered that a large proportion of benefits have been calculated outside the Trust Deed and Rules of the scheme, a decision needs to be made as to whether this is to do with the sample selected or whether this is deemed to have affected all members. If the latter applies, this may result in all members having their benefits recalculated.

Timescales

As stated above, the assessment should be completed within 12 to 24 months. There are, however, a number of other deadlines which need to be met during the assessment period. These include:

- Section 120 notice issued within 14 days of the insolvency event or the insolvency practitioner becoming aware of the pension scheme
- Section 120 notice validated within 28 days of the PPF receiving the notice
- when the Section 143 valuation (see Part 5, Chapter 2.4) is signed off and the valuation summaries are issued the members have 28 days to question the outcome of the valuation, after which it becomes binding Administering Legacy Arrangements

When a scheme enters a PPF assessment period the ongoing administration of the scheme moves to the SAASP.

Reporting Requirements

The project plan is one of the key documents which helps to guide a scheme through the assessment period, and it is crucial that this is kept up to date at all times so all parties are aware of the current status of the scheme.

Another key document is the External Expenses Template. This is where the budgets associated with guiding the scheme through the assessment period are established and agreed based on certain assumptions about the scheme. This is reviewed on an ongoing basis to check that no unexpected costs have arisen or, if they are likely to arise, then a discussion needs to take place to agree any additional costs.

A number of tasks require standard reports to be used which the SAASP and the Trustee Advisory Panel have agreed. For example:

- Data Audit Report
- Personal Details Verification letters
- GMP reconciliation initial and final reports
- Benefit Audit Report
- Money Purchase Benefits Report
- Insured Benefits Report

2.4 ENTERING THE PPF

The final stage is often the production of a 'Section 143 valuation' by an actuary. This is a confirmation of whether the scheme can pay member benefits at or above PPF levels. If not, the scheme will transfer to the PPF. Details relevant to the production of the Section 143 valuation are given on the Valuation Guidance page of the PPF website **incentive-exercises-industry-code-of-practice.pdf**

However, the PPF is permitted to make a funding determination without the need to obtain a Section 143 valuation under changes to the Pensions Act 2004. These changes were made by the Pension Protection Fund (Miscellaneous Amendments) Regulations 2012 which came into effect in July 2012. In order to make a funding determination, the PPF will request the actuary to provide an estimate of the protected liabilities and assets of the scheme in place of a Section 143 valuation. Funding determinations are often used where there is a clear expectation that a scheme is substantially underfunded.

When a scheme's funding is insufficient to provide the PPF level of benefits, the scheme will be accepted for transfer to the PPF.

This transfer or transition involves reviewing and transferring the scheme's assets and member data, and reviewing and terminating any contracts (i.e., with lawyers or advisers) that are in place as part of the scheme.

The transition stage commences during the assessment process to minimise the time it takes to complete the overall assessment period. This stage takes about six months from the point at which the PPF requests the Section 143 valuation and ensures that the scheme is prepared to pass from the trustees into PPF ownership.

Before transition the PPF will issue a list of work, known as the transfer pack, which needs to be completed before transfer can take place.

When the transition is complete, the data has been accepted by the PPF and loaded on to their systems, and the next pensioner payroll is ready to run, a welcome pack is issued to all transferred members. This provides details about the PPF, who to contact and what happens going forward for all members wishing to claim their compensation.

If the assets of the scheme sufficiently cover the PPF liabilities valued within the Section 143 valuation, then the scheme will not be eligible to transfer to the PPF. The trustees then need to apply for quotations from insurance companies to provide at least the PPF level of compensation. There are two main courses of action should this arise:

- **Reconsideration:** if, based on these market quotations, it is found that the scheme cannot be bought out at PPF levels of compensation, the trustees can apply for reconsideration. This is where an abridged version of assessment takes place, valuing the liabilities and assets at a later date. As the Section 143 valuation is calculated at the day before the scheme went into assessment, there is a chance that following the payment of benefits, fees to professional advisers to guide the scheme through assessment and changes in assets, it may mean that at the end of the assessment period the scheme's funding position may have changed. The trustees must apply for reconsideration within six months of being declined entry to the PPF
- **Buy-out of benefits:** if the value of the remaining scheme assets covers the cost of buying out at least the PPF level of compensation as benefits, the trustees need to secure them through buy out. If there are still surplus monies available, then a higher level of benefit will be bought out for members

2.5 PPF COMPENSATION

The level of benefits payable by the PPF where a scheme transfers to it is as follows:

- 100% of the original amount of any pension in payment at the start of the assessment period provided that the member had then reached normal pension age (NPA) under the scheme or was receiving an ill health early retirement pension
- 100% of the benefits in payment to the spouse or dependant of a deceased member
- 100% of the amount of the pension entitlement where the member is over NPA and has not taken his pension (such members can commute 25% of their prospective benefit for a lump sum)
- 90% of the accrued pension entitlements of deferred members and those whose benefits are in payment but who have not yet reached NPA at the start of the assessment period (unless they are receiving an ill health early retirement pension).
- increases in pensions payable from the PPF in respect of pensionable service after 5 April 1997 by reference to CPI capped at 2.5%
- deferred rights to be revalued from the assessment date up to the date of payment by reference to CPI capped at 5% (for pre-6 April 2009 pensionable service) and by reference to CPI capped at 2.5% (for post 5 April 2009 pensionable service), where immediately before the assessment date, the scheme's rules provide for the revaluation of deferred benefits, and
- survivors' benefits for spouses and civil partners of one half of the member's benefit at the date of death

There is provision in the Pensions Act 2014 to increase the cap on compensation for members with periods of pensionable service in excess of 20 years which has recently been brought into force.

On 6 September 2018, the European Court of Justice (ECJ) ruled that PPF compensation may not be less than 50% of a member's accrued rights. This followed a case brought by a former member of the Turner & Newall scheme, whose benefits had been reduced by the PPF from £76,302 pa to £19,189 pa. The judgment will also require the PPF (in some cases) to provide indexation in respect of benefits accrued before 1997. It has been estimated that this judgment will affect the benefits of approximately 1,200 individuals and that it will cost the PPF about £215 million.

In July 2021, the High Court judged that the age-related compensation caps used by the PPF constituted age discrimination. The Court of Appeal subsequently upheld the ruling that the cap was unlawful on the grounds of age discrimination. The pensioners affected have been compensated and the cap is no longer be applied to new PPF retirees.

2.6 FUNDING THE PPF

The PPF is funded by

- levies which are payable annually by eligible pension schemes
- money and other assets which are recovered from the insolvent employers whose schemes are taken on by the PPF
- the assets of the schemes which transfer to the PPF
- investment returns on the assets which are held by the PPF

In this chapter we explain the purpose of the levies payable and how they are calculated.

2.6.1 Levies Payable

PPF Levy

The PPF levy is one of the ways that the PPF funds the compensation payable to members of schemes that transfer to the PPF.

It is payable by all UK DB schemes which would be eligible for entry into the PPF in the event of an employer insolvency. There are some limited circumstances where a scheme will be exempt, for example if a scheme is in a PPF assessment period and certain requirements have been met.

Since the 2017/18 levy year, the PPF has also calculated a levy for schemes with no substantive sponsor (that is, where a scheme has been separated from its previous substantive employer or the employer has suffered an insolvency event and has agreed with the PPF and the Pensions Regulator to run on as a form of restructuring), as a result of arrangements put in place from the start of 2017.

The PPF levy is split into two elements – the scheme-based levy (SBL) and the risk-based levy (RBL) (see Part 5, Chapter 2.6.3). The levy year runs from 1 April to 31 March and following the end of the levy year the levies are calculated and invoices sent to eligible schemes.

Administration Levy

The administration levy is set by the Department for Work and Pensions. Broadly speaking, it covers the PPF's operating expenditure that is related to delivering schemes through the PPF assessment process and administering the PPF levy. Schemes pay an annual amount per scheme member, which varies according to the total size of the scheme.

The Fraud Compensation Levy

The PPF can also raise a fraud compensation levy to fund the Fraud Compensation Fund (FCF). This covers compensation to occupational pension schemes, with insolvent employers, where a dishonest offence has occurred. There is no obligation to raise a FCF levy each year – the 2017/18 levy was the first time a levy has been raised since 2012/13.

In November 2020 a court ruling clarified that occupational pension schemes set up as part of a scam were eligible to claim on the Fraud Compensation Fund (FCF). This is excellent news for the victims of these scams. As a result, another levy was raised in 2021/22 of 75p per member and 30p for master trusts which is the maximum allowed under the current regulations. claims totalled £358.1m as at 31 March 2021. There was another levy in 2022/23 of £1.80 per member for eligible schemes and £0.65 per member for master trusts. This levy is being repeated for 2023/24.

2.6.2 Information Needed to Calculate the PPF Levy

The PPF has a number of data items that they would need to calculate the PPF levy. There are various deadlines for submitting these to the PPF and any information submitted after the relevant deadline will not normally be allowed for in the levy calculation. It is therefore extremely important that each deadline is met and any decisions which are needed in terms of the information to be submitted are made on time as missing the deadline can have significant implications in terms of the amount of the levy which is payable. The main items used in the calculation are described below.

Section 179 Valuation

As part of a scheme's triennial actuarial valuation (see Part 4) a scheme actuary will also carry out a Section 179 valuation that assesses the scheme using assumptions set by the PPF. This information has to be submitted via the scheme's annual return on the Pensions Regulator's Exchange portal no later than 15 months after the effective date of the valuation.

So, if a scheme has a valuation date of 1 April 2021, the Section 179 results will need to be submitted by 30 June 2022. In the period prior to this 15-month deadline, the scheme has the choice as to whether to certify and submit the new Section 179 results ahead of the 31 March 2022 levy calculation data deadline or to continue to use the results already held by the PPF which are likely to have an effective date of 1 April 2018 (i.e., the date of the previous actuarial valuation). These two approaches are likely to give rise to different levy amounts and therefore a decision will often need to be taken as to whether the latest set of Section 179 results should be certified and submitted early or whether it would be beneficial to wait until the 15-month deadline.

Block Transfers

A block transfer is the PPF's terminology for where the liabilities for certain groups of members have been transferred between schemes. Block transfer certificates can be submitted to the PPF via Exchange and give estimated Section 179 valuation figures for the schemes involved in a transfer of liabilities. This information may then be used instead of the formal Section 179 valuation to calculate the levy.

These certificates ensure that schemes that have transferred all their liabilities are not charged a PPF levy, and that the liabilities are correctly recorded at the receiving scheme so that their levy takes account of them.

For the 2022/23 levy year the deadline for submitting block transfer certificates which impact on the period ending 31 March 2023 was 30 June 2023. It was also a requirement that only full transfers where all the members of a scheme have been transferred out could be recognised in this way. Therefore, it is not currently possible to submit a block transfer certificate for partial transfers of members. The PPF will become aware of such cases by means of the next Section 179 valuation which is entered on the Exchange system and in some cases, it might be appropriate to bring the valuation forward so as to ensure that the levy amounts are reduced as soon as practicably possible.

Pension Protection Score

Experian are contracted to provide the PPF with scores that are used to assess the likelihood of an employer becoming insolvent. These scores are known as 'Pension Protection Scores' which are used to determine the Insolvency Risk factor in the calculation of the RBL. The Pension Protection Score at each month end from April to March in any levy year is averaged and this average score is provided by Experian to the PPF.

The Pension Protection Score is determined using a statistical model based on information from a number of sources including a company's accounts. It is possible to access the information being used so that this can be checked.

Bespoke Stress Calculation

A scheme can carry out its own investment risk analysis on its assets and report the results in the annual scheme return via Exchange (see Part 5, Chapter 2.6.3). This is mandatory for schemes with liabilities in the latest Section 179 valuation of £1.5 billion or more and voluntary for all other schemes.

For schemes which do not carry out the bespoke calculation (the majority), a generic stress adjustment is applied in the calculation of the levy (see Part 5, Chapter 2.6.3).

Asset Backed Contributions

An Asset Backed Contribution (ABC) is a contractual funding arrangement under which a stream of income is provided to a scheme, usually via a special purpose vehicle which is established by the sponsoring employer. That income stream is usually given a net present value by the trustees and is treated as an asset, thereby reducing or eliminating the scheme's deficit. Details of the value of the ABC are included in the Section 179 details that are submitted on Exchange.

In addition, a recent valuation of the ABC arrangement must be separately certified and submitted to the PPF on an annual basis by a specified deadline (31 March 2023 for 2022/23) if it is to be allowed for in the levy calculation. As this is a complex and high-risk area, the PPF has set out strict requirements in respect of the certification process including that the valuation must be provided by a person who is appropriately qualified and meets certain specified requirements.

Scheme Structure/Last Man Standing Schemes

Trustees have to certify on the annual scheme return the legal structure of the scheme so that it can be determined whether it classifies as a 'last man standing' scheme. From this a Scheme Structure Factor is determined and used in the calculation of the RBL.

Prior to 2015/16, the information provided on the scheme return was used by the PPF and a Scheme Structure Factor of 0.9 was used for all schemes which had stated that they were 'last man standing' schemes. Since the 2015/16 levy year, in order for schemes to benefit from the Scheme Structure Factor, trustees have been required to confirm to the PPF by a specified deadline that they have received legal advice that their scheme is 'last man standing'.

A 'last man standing' scheme is a multi-employer scheme with rules that do not include an option or requirement to segregate assets if an employer ceases to participate, but which is not a centralised scheme for non-associated employers.

Giving such schemes a reduced Scheme Structure Factor recognises that in the event of some but not all the participating employers becoming insolvent, the responsibility for the liabilities of the scheme will be passed to the remaining employers until in effect there is only one employer left. With effect from 2015/16 the calculation of the Scheme Structure Factor was also amended to take into account the concentration of members across the various employers which participate in a pension scheme.

Deficit Reduction Contributions

Contributions that have been paid into the scheme since the date of the latest Section 179 valuation can be certified by the scheme actuary and taken into account in the levy calculation.

Deficit reduction contributions are defined as total contributions less:

- the cost of accruing scheme benefits, if any, since the last Section 179 valuation
- scheme expenses (if met out of scheme assets) that have been incurred since the last Section 179 valuation
- the cost of any augmentations that have been granted, if any, since the last Section 179 valuation
- any benefits that were paid out of the scheme before the last Section 179 valuation that are not reflected in the asset value at the valuation date

Contributions that have been made to the scheme to facilitate purchase of an ABC arrangement, or any coupon payments from such an arrangement, should not be included.

The deficit reduction contributions must be certified on the Exchange system before a stipulated deadline each year (24 April 2023 for 2023/23). Contributions which have been certified in previous years will be taken into account by the PPF until a new Section 179 valuation or replacement deficit reduction certificate is submitted.

Contingent Assets

Contingent assets can reduce the risk that an insolvency event results in a claim on the PPF or reduce the size of a claim if one occurs.

There are currently three different types of contingent assets that are potentially recognised in the levy calculation. In order for the PPF to recognise them they have to satisfy certain requirements and be certified (or recertified) on Exchange by the relevant deadline.

Type A contingent assets are parent or group company guarantees. These allow the Pension Protection Score of a group company, or another entity related to the scheme's employer to be taken into account in the levy calculation in place of that of the employer (see Part 5, Chapter 2.6.3).

Type B contingent assets are security over cash, UK property or securities. Type C contingent assets are letters of credit or bank guarantees. Both Types B and C contingent assets which have been appropriately certified reduce the level of the Section 179 underfunding in the scheme (see Part 5, Chapter 2.6.3).

2.6.3 How to Calculate the PPF Levy

The details on how to calculate both the SBL and RBL are set out in the PPF's Determination under section 175(5) of the Pensions Act 2004.

This is reviewed and consulted on every year so is subject to change.

Roll-forward, Smoothing and Stressing

The asset and liability figures from the latest Section 179 valuation on Exchange are used in the calculation of the SBL and the RBL.

The 'smoothing' of the funding will be over a five-year period to the end of the levy year. The PPF rolls forward the assets and liabilities to reflect market conditions and then carries out a 'basis switch', substituting five year daily averaged yields (arithmetic mean) for the liability calculation and five year daily averaged asset indices (arithmetic mean) for the asset calculation. The liabilities are then rolled forward (or backwards) to the midpoint of the five-year averaging period. These are generally referred to as the 'smoothed assets and liabilities'.

The smoothed liability figure is used in the SBL and in calculating the cap on the highest RBL a scheme can pay.

The next step in transforming the smoothed asset and liability figures is to take account of investment risk. To do these generic stresses are applied to the smoothed liabilities and specified stresses to the smoothed assets according to the degree of risk associated with each type of asset held by the scheme. These are referred to as the "stressed assets and liabilities".

The principle behind this is that if

- you have two schemes with identical assets by value at a particular date, and
- one of them invests in riskier assets than the other

then, ignoring all other factors, the scheme which invests in riskier assets is likely to represent a larger risk to the PPF in terms of claim amounts than the scheme which has taken a more risk averse approach.

For schemes with liabilities of £1.5 billion or more in the latest Section 179 valuation, it is mandatory for them to carry out their own investment risk analysis on their assets (see Part 5, Chapter 2.6.2) in line with PPF guidance. This is known as a 'bespoke stress calculation' and the stress results must be entered on the annual scheme return. Then, a single overall scheme stress factor is applied to the smoothed assets.

Scheme-based Levy

The SBL is based on a scheme's smoothed liabilities and all eligible schemes have to pay the SBL regardless of their funding position.

For 2023/24 the formula to calculate the SBL is:

0.000019 (reduced by 10% from the previous year) x smoothed liabilities

The Risk-based Levy

The RBL is based on the likelihood of a scheme making a claim on the PPF and the potential size of that claim. It takes account of the risk of a scheme's sponsoring employers becoming insolvent and the amount of compensation that might then be payable by the PPF.

For 2023/24 it is calculated using the formula: underfunding risk (U) x insolvency risk (IR) x levy scaling factor

U is the difference between the value of a scheme's liabilities and assets and represents the size of a scheme's potential claim on the PPF. It is normally determined using the scheme's stressed assets and liabilities. However, in a small number of circumstances the smoothed assets and liabilities can give rise to a higher figure in which case the higher amount is used. Account is also taken of any valid Type B or C contingent asset arrangements, deficit reduction contributions and certified asset backed contribution value including coupon payments (see Part 5, Chapter 2.6.2).

IR represents the likelihood of a scheme's employer becoming insolvent taking into account the Scheme Structure Factor. Pension Protection Scores are provided to the PPF by Experian and the average score for the year in question places them in one of ten levy bands. Each levy band has an associated Levy Rate that is used in the calculation of IR. The Levy Rate may be modified where there is a Type A contingent asset (see Part 5, Chapter 2.6.2).

The general levy is based on the total number of members in the scheme at the end of the scheme year before last.

Here are some examples:

- Levy payable on 1 April 2024 would be based on total scheme membership taken as at the scheme year end prior to 1 April 2023 - if the scheme year end is 5 April, membership will be taken as at 5 April 2022.
- ABC Pension scheme is a defined benefit pension scheme and is eligible for the 2024 levy invoice. The membership figure of 200 was taken as at 5 April 2022. The general levy rate for 100 - 999 members is £4.58 per member, therefore the amount payable for the general levy is £4.58 x 200 = £916. If the scheme had had more members for example 500,000 the levy would be £1.43 x 500,000 = £715,000.

Students are not expected to know all the detail contained within the PPF website, but this should provide useful background information in terms of understanding how the levies are determined.

The IR is determined by multiplying the Levy Rate by the Scheme Structure Factor. The Scheme Structure Factor for a scheme that has the option to segregate assets when an employer ceases to participate in the scheme is 1.0 (i.e., no adjustment is made in the levy formula). For a 'last man standing' scheme (see Part 5, Chapter 2.6.2) the factor is calculated to reflect the extent to which a scheme's membership is distributed between the different employers.
The factor tends towards 0.9 the more employers there are and the more evenly distributed the membership is. The factor tends towards 1 the smaller the number of employers and the more biased the employee numbers are to one employer.

The LSF scales the amount that the PPF collects from all schemes to ensure that the total levy collected roughly matches the amount that they estimate they will collect in any one year. The levy scaling factor for 2023/24 is 0.37.A reduction of 10% from the previous year.

Capping

The RBL is capped to protect the most vulnerable schemes. The cap for 2023/24 remains at 0.25% of smoothed liabilities. Where the RBL calculated using the above formula exceeds 0.75% of smoothed liabilities, the cap is applied and the RBL is calculated using the following formula:

Smoothed liabilities x 0.0025

2.7 FINANCIAL ASSISTANCE SCHEME

Under section 286 of the Pensions Act 2004, the Secretary of State for Work and Pensions was given powers to establish the Financial Assistance Scheme (FAS) to provide benefits for certain members of pension schemes, which are not money purchase schemes, and which do not qualify for the PPF. FAS is now administered by the PPF.

FAS offers help to some people who have lost out on their pension because:

- they were a member of an underfunded DB scheme that started to wind up between 1 January 1997 and 5 April 2005, and
- their scheme began to wind up and did not have enough money to pay members' benefits, and
- the employer cannot pay the shortfall because it is insolvent, no longer exists or no longer has to meet its commitment to pay its debt to the pension scheme, or
- the scheme started to wind up after 5 April 2005 but is ineligible for help from the PPF due to the employer becoming insolvent before this date

The majority of schemes where members were eligible for benefits from FAS have now been dealt with and the benefits allocated to scheme members where the benefits are in payment or will become payable in the future. There are, however, a handful of schemes which require some legal rulings to be finalised before they can be completed.

Summary

If the employer sponsoring an underfunded DB scheme suffers a 'qualifying insolvency event', it may be eligible to enter the Pension Protection Fund (PPF).

To check eligibility, the scheme has to go through an assessment period which normally takes between 12 and 24 months. This involves a number of different processes, including an audit of membership data to ensure all records are up to date, and a benefit audit to ensure benefits have been correctly calculated.

If the scheme was formerly contracted out, scheme membership and GMP details need to be reconciled with the records held by HMRC.

To ensure that the assessment process runs smoothly, it is important that it is properly managed, with regular liaison between the parties involved. Scheme trustees must also keep the members informed about the progress of the assessment.

The final stage in the assessment process is for the actuary to produce a Section 143 valuation, which shows whether or not the scheme's funds can provide benefits at the level which the PPF would provide. If the scheme cannot do so, the scheme will transfer to the PPF.

The PPF does not provide full scheme benefits to all members, as there are limits on the amount of PPF compensation and on increases to benefits in payment.

PPF compensation is funded in part by means of several levies, in particular the PPF levy which is based on the level of underfunding and insolvency risk. The PPF calculates the amount of the PPF levy and takes a number of different factors into account in its calculations.

The Financial Assistance Scheme also pays compensation for members of certain schemes which wound up underfunded before the PPF came into existence in April 2005.

Self Test Questions

- Describe the different notices which have to be given if an employer suffers a qualifying insolvency event, including who must give the notices and to whom.
- Explain what actions need to be taken by a scheme in a PPF assessment period following receipt of a benefit audit.
- List four different reports which need to be produced during a PPF assessment period.
- Outline the amount of benefits which may be payable to a scheme's members once it has entered the PPF.
- Describe the different elements which make up the calculation of the risk-based levy.
- Outline the circumstances in which a scheme may be eligible for the Financial Assistance Scheme.

APPENDIX A

Career Average Revalued Earnings Schemes

Year (1 April to 31 March	Year 1	Year 2	Year 3	Year 4	Year 5
Salary	£14,000	£14,500	£15,000	£14,000	£13,500
					£13,500 X 1/70th = £193
				£14,000 X 1/70th = £200	Plus revaluation on Year 4 earnings £14,000 X 1.029 X 1/70th = £206
			£15,000 X 1/70th = £214	Plus revaluation on Year 3 earnings £15,000 X 1.029 X 1/70th = £221	Plus revaluation on Year 3 earnings £15,000 X 1.029 X 1.029 X 1/70th = £227
		£14,500 X 1/70th = £207	Plus revaluation on Year 2 earnings £14,500 X 1.032 X 1/70th = £214	Plus revaluation on Year 2 earnings £14,500 X 1.032 X 1.029 X 1/70th = £220	Plus revaluation on Year 2 earnings £14,500 X 1.032 X 1.029 X 1.029 X 1/70th = £226
	£14,000 X 1/70th = £200	Plus revaluation on Year 1 earnings £14,000 X 1.032 X 1/70th = £206	Plus revaluation on Year 1 earnings £14,000 X 1.032 X 1.032 X 1/70th= £213	Plus revaluation on Year 1 earnings £14,000 X 1.032 X 1.032 X 1.029 X 1/70th = £219	Plus revaluation on Year 1 earnings £14,000 X 1.032 X 1.032 X 1.029 X 1.029 X 1/70th = £226
Total Pension to Date Each Year	**£200**	**£413**	**£641**	**£860**	**£1,078**

In this example, after five years the member has earned a total pension of £1,078 payable from Normal Pension Date. The earnings for each year will continue to be revalued annually until retirement.

This example assumes that salaries are revalued in line with the Consumer Prices Index (CPI). CPI is assumed to have been 3.2% for years one to three, and for years four and five is assumed to be 2.9%.

APPENDIX B

Former Contracted Out Scheme Structure

The Colourboxx Final Salary Plan is a formerly contracted out scheme. The contracted-out benefit structure is as follows.

Scheme Details

- Final salary scheme providing a pension of 1/60 of final salary for each year of pensionable service
- Contracted out from 6 April 1978 to 5 April 1997 on GMP basis
- Contracted out from 6 April 1997 to 5 April 2016 on reference scheme test (RST) basis

Contracted Out on GMP Basis – What Does This Mean?

- Benefits for service from 6 April 1978 to 5 April 1997 must be at least equal to the Guaranteed Minimum Pension (GMP)
  - GMP = pension approximately equal to the amount of State additional pension which individuals would accrue in the State scheme during scheme membership if not contracted out
- Individual benefit test at member level
- Conditions applying to GMP:
  - Paid from 'GMP payment age' (65 for men and 60 for women)
  - Revalued in line with earnings, or at a fixed percentage rate if the member left contracted out service at least one full tax year before 65/60. For active members ceasing contracted out service on 6 April 2016, the alternative fixed percentage rate applies if the member leaves pensionable service at least one full tax year before 65/60
  - Generally, not possible to offset revaluation against other scheme benefits
  - Increased for late payment after 65/60
  - Cannot be commuted on retirement, unless pension is trivial or member is in serious ill health
  - GMP based on contracted out service from 6 April 1988 ('post '88 GMP') increases in payment at 3% a year or by rise in prices if less - If member dies:
  - half of the total GMP is payable to the member's widow
  - half of the post '88 GMP is payable to the member's widower, registered civil partner, or widow following a same sex marriage

Contracted Out on RST Basis – What Does This Mean?

- Benefits for service from 6 April 1997 to 5 April 2016 must be broadly equivalent to those payable from a 'reference scheme'
- Details of 'reference scheme' were set out in legislation – accrual rate (up to and including the 2008/09 tax year) was 1/80 of 90% of earnings between the lower and upper earnings limits. From 6 April 2009 to 5 April 2016, the accrual rate was 1/80 of 90% of earnings between the lower earnings limit and the upper accrual point
- Comparison against reference scheme made at scheme level – no minimum level of member's benefits (in contrast to GMP)
- Conditions applying to benefits based on contracted out service from 6 April 1997 – 5 April 2016:
  - Paid to both men and women from same age
  - Leaver's benefits revalued in line with prices up to a maximum of:
  - 5% a year compound for pensionable service before 6 April 2009
  - 2.5% a year compound for pensionable service from 6 April 2009 to 5 April 2016
  - Not possible to offset revaluation against other scheme benefits
  - Increased for late payment in line with scheme's usual late retirement rules
  - Can be commuted on retirement in line with normal HMRC rules and limits, but any benefits which exceed the member's available Lifetime Allowance cannot be commuted for a lifetime allowance excess lump sum
  - Can be fully commuted on grounds of triviality or serious ill health if scheme rules allow
  - Must increase in payment in line with prices up to a maximum of:
  - 5% a year for benefits based on service bween 6 April 1997 and 5 April 2005
  - 2.5% a year for benefits based on service from 6 April 2005 to 5 April 2016
  - If the member dies, half of the pension is usually paid to the member's spouse, registered civil partner, or survivor from a same sex marriage
- Can pay a contributions equivalent premium to HMRC to reinstate members in the State scheme, if they leave before completing two years' qualifying service, have a period of contracted out service before 6 April 2016 and take a refund of their contributions

APPENDIX C

GMP Revaluation for Early Leavers

Full Rate Revaluation

Full rate revaluation is calculated using the increases published in the Average Weekly Earnings index, as declared under Section 148 of the Social Security Administration Act 1992. If Section 148 orders are used for revaluation, the earnings factors used in the GMP calculation continue to be revalued by Section 148 orders up to and including the order for the last complete tax year before GMP payment age or earlier death.

Fixed Rate Revaluation

For fixed rate revaluation, the percentage varies depending on the date contracted out employment (or, from 6 April 2016, pensionable service) ceased, for example:

- 3.5% for terminations after 5 April 2017
- 4.75% for terminations between 6 April 2012 and 5 April 2017
- 4% for terminations between 6 April 2007 and 5 April 2012, and soon

The revaluation percentage that applies is determined by the date of termination of contracted out service (pensionable service from 6 April 2016) and does not change thereafter. The revaluation period relates to the number of complete tax years between the date of termination of contracted out service and GMP payment age or earlier death.

For active members ceasing contracted out service on 6 April 2016, full rate revaluation continues to apply to the member's GMP until the member leaves pensionable service. Fixed rate revaluation then applies for the revaluation period relating to the number of complete tax years between the date of termination of pensionable service and GMP payment age or earlier death.

Limited Rate Revaluation

Limited rate revaluation is at the lower of Section 148 orders and 5% a year compound. Limited rate revaluation ceased to be an option for schemes from 6 April 1997. Before 6 April 1997, a scheme using this method had to pay a limited revaluation premium at the time of leaving to provide any revaluation required over 5% through the State Pension Scheme.

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