



Pensions reform proposals: the White Paper

Employment, pensions and benefits: briefing 90

'Simplicity, security and choice: Working and saving for retirement – Action on occupational pensions'

In December 2002 the government published the pensions Green Paper *Simplicity, security and choice: Working and saving for retirement*.¹ Having received some 800 responses from a wide range of groups and individuals, it published, on 11 June 2003, its White Paper on pensions reform, *Simplicity, security and choice: Working and saving for retirement – Action on occupational pensions*.

This briefing identifies the main proposals for change outlined in the White Paper that will be of interest to employers and trustees of occupational pension schemes. Most of the changes will come into force in April 2005.

The proposals fall into three categories:

- improving member protection;
- making pension provision easier for employers; and
- choices and planning for retirement.

Improving member protection

The possibility raised in the Green Paper that pension schemes should rank as priority unsecured creditors on the winding-up of an employer has been dropped. The government intends, however, to introduce a number of other measures aimed at improving the security of pensions.

What is a White Paper?

A White Paper is published by the government, indicating its intention to legislate. It follows the publication of a Green Paper, a formal discussion document, and subsequent consideration of responses from interested bodies.

Executive summary

On 11 June 2003 the government published its White Paper on pension reform. Its proposals are aimed at improving member protection, making pension provision easier for employers and helping individuals to make informed choices about retirement planning. Measures include establishing a pensions protection fund, requiring solvent employers to meet their pensions promises in full, revising the priority order on winding-up, requiring employers to consult before making scheme amendments, extending the scope of Tupe to private sector pension schemes, reducing LPI and replacing the MFR with scheme-specific funding requirements.

The Pensions Protection Fund

The Pensions Protection Fund (PPF) will be a compensation scheme established by statute. It will be similar to the Pension Benefit Guaranty Corporation (PBGC) in the US. There will be no formal guarantee of funding for the PPF from the government. It is intended to protect private sector defined benefit scheme members whose employers become insolvent with unfunded liabilities in their pension scheme. The PPF will pay a maximum of 100 per cent of pensions in payment and 90 per cent of the benefits of those still working.

To deter employers from winding up leaving the deficit in the pension scheme, the government proposes to cap the maximum amount guaranteed by the PPF at a level equivalent to the pension expected by those on a final salary of between £40,000 and £60,000. The government will take views on the right level of the cap.

The PPF will be funded by a levy payable by all schemes covered by the PPF ie private sector defined benefit schemes.

In order to minimise the risk of sponsoring employers relying on the compensation scheme and therefore reducing the funding of their schemes, schemes in deficit will pay not only the flat-rate levy, but also an additional premium.

It is not clear how this funding level will be calculated by the PPF, nor what powers it will have to check on the actions of employers (the PBGC has wide powers to insist on funding from employers).

¹ See our briefing no. 82.

Solvent employers: full buy-out

Employers not in liquidation whose pension scheme starts to wind up will have to meet their pension promise in full.

The government has proposed regulations to provide that employers are required (unless they enter liquidation first) to fund schemes which start to wind up on or after 11 June 2003² to meet the full buy-out costs of the rights accrued by all scheme members (not just pensioners). This debt will be (as at present) one which the scheme trustees will be able to compromise. However, they owe fiduciary duties in doing so. This means that such a compromise is only likely if the trustees can show that they will get more from a compromise than they would from the employer's liquidation. In practice trustees are likely to look for the court to approve such a compromise.

An employer will not be able to take a refund of surplus unless the scheme is funded to a level sufficient to allow full buy-out.

A consultation draft of The Occupational Pension Schemes (Winding Up and Deficiency on Winding Up etc.) (Amendment) Regulations 2003 was published on the same date as the White Paper.

The potential cost to employers of this reform is likely to be high. The extent to which the cost may be shared with the members is not yet clear.

New priority order on winding-up: fairer sharing of assets

The priority order which applies on winding-up is to be changed to ensure the fairest possible sharing of assets.

The current statutory priority order, which ranks pensions in payment and their indexation higher than the benefits of other members, has been criticised as being unjust towards non-pensioner members, especially those who have worked longer and are nearer to retirement age.

The government therefore intends to publish draft regulations which will:

- give greater protection to members who have contributed to the scheme longer; and

² The White Paper states that this will apply also to schemes already in the process of winding up on 11 June 2003; however, the consultation draft of the regulations provides otherwise. The government has now confirmed that the White Paper contained an error and that the draft regulations are correct.

- give priority to the rights of non-pensioners over the future indexation of pensions in payment.

Consultation will take place of these draft regulations over summer 2003, and they are expected to come into force in the autumn.

New pensions regulator

A new pensions regulator is to be established, built on the foundations laid by the Occupational Pensions Regulatory Authority but with wider powers. The new regulator will have powers proactively to tackle fraud, bad governance and poor administration and to encourage best practice through increased education and guidance. It will have powers to sanction and undertake compliance visits.

The new regulator will also have power to issue codes of practice, of similar status to the ACAS codes, covering such issues as proper conduct of trustees' meetings, scheme dispute procedures and good practice in scheme communication with members.

It is not yet clear how the powers of the new regulator will tie in (if at all) with the powers and funding concerns of the PPF.

Trustee training

Legislation will be introduced to require trustees to be familiar with investment and their other responsibilities. The codes of practice referred to above are to provide guidance on how this legal requirement could be satisfied, covering matters such as training, qualifications and experience and governance issues such as record keeping.

Extending Tupe to pensions

Pensions are at present excluded from the scope of the Transfer of Undertakings (Protection of Employment) Regulations (Tupe). The government plans to extend the protection of Tupe to the pension schemes of workers in the private sector by requiring that, on a business transfer, employers offer as a minimum a stakeholder scheme with employer contributions matching employee contributions up to 6 per cent of salary. The White Paper indicates that this obligation may also apply on a change of control of a corporate employer (this may be intended to apply even if Tupe does not).

Vesting

The Green Paper suggested abolishing the current maximum two-year vesting period. Schemes are currently able to provide that members who leave an occupational pension scheme during the first two years of membership have no preserved rights – in practice they are given a refund of their own contributions. The White Paper now proposes that employees who have been scheme members for at least three months and who leave pensionable service during the first two years must be offered the choice of a refund of contributions (less tax) or a transfer payment (including the value of the benefits that would have been preserved), which they must transfer out of the scheme.

The aim is to enable those who change jobs frequently to start to build up a private pension. Those respondents to the Green Paper who objected to the abolition of the two-year vesting period on the grounds of administrative unworkability are unlikely to be persuaded that a three-month vesting period will dissuade employers from introducing longer waiting periods.

No compulsory membership

The majority of respondents to the Green Paper opposed the proposal to allow employers to make compulsory membership of their occupational pension scheme a condition of employment. In the light of this, the proposal has been abandoned.

Instead, the government believes there may scope for the new pensions regulator to issue guidance that employers should normally admit employees to their pension scheme unless employees actively opt out of it. For the longer term, the issue of compulsory scheme membership may be something the Pensions Commission³ will wish to examine.

Consultation with employees

The proposal to introduce a requirement on employers to consult before making changes to pension schemes was widely welcomed by respondents. The intention is that this should cover significant rather than minor changes. The government is looking at how best to achieve this alongside consideration of how to implement the EU Information and Consultation Directive. A consultation

document on the implementation of the Directive will be issued during summer 2003.

It is unclear who the employer will be required to consult with. Possibilities include the trustees, all the scheme members, the active members only or representatives of the employees (eg works councils or trade unions). There may be a complication for multi-employer schemes: if a participating employer in due course establishes a works council under the new legislation on national works councils, that works council will be for the employees of that employer only. An employer under a group scheme might therefore have to consult with several national works councils.

Making pension provision easier for employers

The government intends to implement a number of changes to simplify and enable greater flexibility in pension provision for employers and pension providers.

Replacement of the MFR

The minimum funding requirement (MFR) is described by the government as a flawed approach which distorted investment decisions for some schemes and increased regulation and costs for employers without delivering the expected level of security.

The MFR is to be replaced by scheme-specific funding requirements to allow schemes greater flexibility to match their investment strategy to the profile of their members; for example, schemes with younger members may wish to invest more heavily in higher return/higher risk assets.

When the new regime will come into force is not clear, but when it does it is expected to result in a cost saving to schemes.

Employers, trustees and the scheme's actuary will be required to work together to develop an appropriate funding strategy for their scheme. The key elements of the scheme-specific funding requirements will be as follows:

- scheme trustees will be required to draw up a statement of funding principles;
- trustees will still be required to obtain a full actuarial

³ The recently established independent body, chaired by Adair Turner, which is to keep under review the system of voluntary pension provision and long-term savings in the UK.

- trustees will still be required to obtain a full actuarial valuation of their scheme at least every three years;
- following the valuation, the trustees will still be required to put in place a schedule of contributions;
- where trustees and employers cannot reach agreement on issues fundamental to the funding of the scheme, the trustees will be given, *as a last resort*, powers to freeze or wind up the scheme⁴;
- trustees will be required to send regularly updated information to scheme members each year, containing key information about the funding position of their scheme, in line with the likely requirement of the EU Occupational Pensions Directive; and
- the scheme actuary's duty of care towards scheme members will be clarified.

The detail of this needs to be clarified. However, it seems likely that any scheme-specific funding requirement will be an underpin for any funding requirement under the scheme rules. If the scheme currently gives control of funding to (say) the trustees, this is likely to continue.

Lower LPI

The Green Paper sought views on the recommendation in the Pickering Report⁵ to remove LPI, the requirement that defined benefit schemes must increase pensions in payment earned for service after 5 April 1997 in line with price inflation, capped at 5 per cent per annum.

Because inflation has been lower than was expected when LPI was introduced (averaging 2.4 per cent over the years since 1997), 5 per cent is now considered to be too high and to cause indexation to consume too high a percentage of overall contributions to pension schemes. On the other hand, some level of protection from inflation remains desirable. The government has therefore decided to retain LPI but to reduce the cap to 2.5 per cent per annum. Pensions already in payment will be unaffected by this change.

Again the detail is not clear. However, it seems likely that this change will only apply to benefits relating to pensionable service after the change (ie current deferred members may not be affected). Similarly those schemes

which already give indexation as a matter of scheme design will have to consider how (if at all) it can be changed for future service.

It seems that the minimum level of revaluation for deferred members is not affected.

Survivors' benefits

The Pickering Report recommended that pension schemes should not have to provide benefits for surviving spouses of members. Most respondents to the Green Paper, however, felt that this would not be desirable or effective and no change is therefore proposed.

Simplifying the legislation

The level of prescription in the legislation relating to scheme administration and governance will in future be based on the risk to the benefits of scheme members. The areas in which simplification is intended are set out below.

Scheme amendments

Section 67 of the Pensions Act 1995 is to be relaxed so that schemes will be able to make rule amendments if:

- there is a power in the scheme rules to make the change;
- the change does not involve converting defined benefit rights into defined contribution rights;
- the trustees approve the change;
- the total actuarial value of members' accrued rights at the point of any change is maintained (this seems, by the use of the plural, to be a group test and not member by member);
- pensions already in payment are not reduced; and
- members are consulted before a change is made.

The proposed changes, based on recommendations made in the Pickering Report, were welcomed by many respondents to the Green Paper, in particular the facility to replace benefits with alternative benefits of equal value if the assumptions underlying the scheme change.

Details of the extent of consultation required are not yet available; however, the built-in safeguard for scheme members opposing a proposed change is that trustee approval will be required.

⁴ Note that this will now trigger a buy-out debt on the employers.

⁵ *A Simpler Way to Better Pensions – an Independent Report*, Alan Pickering, 2002.

Member-nominated trustees

Schemes will still be required to have at least one-third member-nominated trustees (MNTs). The Green Paper proposed that revised MNT legislation should focus on the required outcome rather than the process. Because consultation responses broadly supported this, the government is adopting the more radical of the two proposed options for simplifying the MNT regime. This provides for minimum requirements in legislation backed by guidance from the new pensions regulator. This flexibility will make it easier for schemes to meet the MNT requirement in a manner suitable to their circumstances.

Removal of the requirement on schemes to provide facilities for AVCs

The tax rules are to be simplified to allow scheme members also to take out personal pensions. So the requirement for occupational schemes to offer members a facility to make additional voluntary contributions (AVCs) will be removed. Where schemes do not offer AVC arrangements voluntarily, members will have the flexibility to make their own arrangements.

Streamlining the rules of contracting-out

A number of proposals have been made:

- to simplify the administration of guaranteed minimum pensions (GMPs) (which ceased to accrue in 1997) and the anti-franking legislation which protects benefits in excess of the GMP from being eroded – the mechanism for achieving this has yet to be worked out;
- to relax restrictions on contracted-out rights forming part of the tax-free lump sum permitted under Inland Revenue rules;
- to relax restrictions preventing contracted-out rights being paid at the same time as other benefits;
- to increase the level at which small pensions derived from contracted-out rights can be commuted;
- to remove the requirement to obtain member consent for the commutation of a pension into a lump sum when their entitlement consists solely of equivalent pension benefits; and
- to extend commutation on grounds of serious ill-health to contracted-out rights in appropriate personal pensions (this did not form part of the Green Paper proposals, but some respondents raised the matter).

The consultation confirmed the need to retain contracted-out mixed benefits schemes and, accordingly, these will not be abolished.

With regard to other tax matters, the government also announced on 11 June that the date for implementing the proposed new simplified tax regime for pension schemes will be put back to 6 April 2005. The detail is to be consulted on this autumn.

Other simplifications

The government plans to:

- rationalise rules governing communication with members;
- streamline the internal dispute resolution procedure;
- clarify the existing jurisdiction of the pensions ombudsman;
- simplify the pensions on divorce legislation by abolishing safeguarded rights (the ex-spouse's share of contracted-out rights) and aligning normal benefit age as the earliest age from which a pension share may be payable for all private pension arrangements; and
- simplify the tax treatment of multi-employer schemes (the NAPF having been invited to work with the Inland Revenue to find a solution to the problem of cross-subsidy between unconnected employers).

Choice for all – planning for retirement

The government believes that people should have the choice over how and when they save and how long they work and wants to ensure that they have sufficient information to make effective choices.

Information

The government intends to make the importance of retirement planning more high profile and to ensure that sufficient information is provided to enable individuals to be aware of the choices they can make, and where they can obtain information and advice to help them make those choices.

It intends to work with others to build a 'robust and sustainable strategy for financial planning for the future'. The Financial Services Authority will launch an extensive programme of work in summer 2003.

Pension forecasts

Earlier this year, members of defined contribution pension schemes began to receive the first statutory money purchase illustrations. This initiative will be extended so that all types of pension scheme will be required to issue annual benefit statements to their members showing the amount of pension they have already built up in their scheme as well as the likely amount they will receive when they retire. (Most large defined benefit schemes are already providing this voluntarily.)

Combined pension forecasts

In May 2003 the government started its five-year programme of issuing state pension forecasts. It now wishes to encourage employers and pension providers to provide combined pension forecasts.

A combined pension forecast adds state pension information to the forecast of an individual's current occupational or private pension scheme. If employers and pension providers do not respond adequately to this initiative, legislation will be put in place to require combined pension forecasts to be issued regularly.

Retirement planner

As proposed in the Green Paper, the government will continue to develop a web-based retirement planner to enable people to view their total projected pension income from both state and private sources. The first elements of this are expected to be available next year.

Provision of information by employers

The Green Paper proposed a range of options that require employers who provide no pension or make a contribution of less than 3 per cent of salary to offer access to a minimum level of information and advice. These options are:

- a state pension forecast and a reminder of the stakeholder pension scheme designated by the employer;
- a pension information pack;
- a presentation from the designated stakeholder pension provider or other authorised retailer about pensions and saving for retirement; or
- an interview with the designated stakeholder pension provider or other authorised retailer about pensions and saving for retirement.

A pilot scheme for employer-based information will be carried out to evaluate the effectiveness of different forms of pension information and advice in the workplace. Legislation may be put in place if the pilot proves successful.

Greater choice – flexible retirement

The intention is to give people greater choice about flexible retirement. State pension age is to be maintained at 65, as it is believed that raising it would disproportionately affect those on lower incomes, but a number of initiatives are proposed:

- people should have the right to work longer, but this should be voluntary;
- although state pension age will remain 65, there will be flexibility to take the state pension later;
- age discrimination is to be outlawed – there will be further consultation on the implementation of the age discrimination legislation during the summer;
- tax legislation will be introduced to promote flexible retirement, ie to enable employees to carry on working for the same employer while drawing on their occupational pension;
- the earliest age from which a pension may be taken will be increased from age 50 to age 55 by 2010; and
- the normal pension age in public service schemes will be increased from 60 to 65 for new entrants.

What should schemes and employers do now?

Until more draft legislation is available to flesh out the proposals and until the timetable for reform becomes clearer, there is a limit to the action which can be taken immediately. Employers and trustees should, however, start to consider the action they may wish to take once the legislation is in place.

Employers should consider whether they might wish to reduce LPI for future service, and consider the implications of the introduction of the PPF and of the full buy-out requirement on the winding-up of a scheme by an employer not in liquidation.

The government's current timetable is summarised below.

The following timetable for implementation of the proposals is adapted from that contained in the White Paper.

Time	Event
11 June 2003	<ul style="list-style-type: none"> • Publication of draft regulations to ensure that solvent employers who choose to wind up their schemes will meet their pension promise in full – full buy-out.
Summer 2003	<ul style="list-style-type: none"> • Government response to the Sandler review. Details of the revised sales regime, and product specifications, will be finalised following consultation on the Sandler recommendations. • Publication of draft regulations to change the priority order on winding-up. • Laying of regulations on full buy-out effective from 11 June 2003. • Further consultation on proposals for age discrimination legislation. • Consultation on EU Information and Consultation Directive.
Autumn 2003	<ul style="list-style-type: none"> • Further details of plans to reform the taxation of pension schemes. • Laying of regulations to change the priority order on winding-up.
2004	<ul style="list-style-type: none"> • ‘First elements’ of web-based retirement planner available.
Summer 2004	<ul style="list-style-type: none"> • Interim report from the Pensions Commission.
Late 2004	<ul style="list-style-type: none"> • Age discrimination legislation laid in parliament. • Report from the Employer Task Force.
Spring 2005	<ul style="list-style-type: none"> • Earliest possible date for most reforms to pensions law to come into force, including amendments arising from the EU Occupational Pensions Directive. • Possible implementation of reforms to the taxation of pension schemes, including flexible retirement.
Summer 2005	<ul style="list-style-type: none"> • First report from the Pensions Commission.
Late 2006	<ul style="list-style-type: none"> • Age discrimination legislation comes into force.
2010	<ul style="list-style-type: none"> • State pension age for men and women equalised. • Minimum pension age will have been increased from age 50 to age 55 for all pension scheme members.

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