



April 2004

BRIEFING

Pensions Bill 2004

Employment, pensions and benefits: briefing 107

Summary

The Pensions Bill 2004 introduces the widely publicised Pensions Protection Fund. A new Regulator will have wide powers to seek to reduce claims on the protection fund and protect members' interests. The minimum funding requirement is finally abolished and the framework for the new scheme specific funding approach is introduced. Compulsory member nominated trustees are introduced along with an apparent attempt to increase (or clarify?) trustees' duties. The Bill contains other changes, including to the statutory restrictions on amendments and the reduction in compulsory pension increases.

The Pensions Bill 2004 was published on 11 February 2004. It has moved through the committee stage of the House of Commons with incredible speed. The last session is due on 29 April. It has been widely publicised for the introduction of a new Pensions Protection Fund (PPF) to protect specified levels of benefits in the event of employer insolvency. Schemes will be affected by the new levy (flat and risk based) and by the new Regulator, which will have wide powers to seek to protect members' interests and reduce the risk of claims on the PPF. The Bill also contains long awaited provisions to replace the inflexible minimum funding requirement (MFR) with an allegedly more scheme-based approach; attempts to increase (or clarify?) the standard of care of scheme trustees; and contains some simplification measures, in particular regarding section 67 of the Pensions Act 1995 relating to scheme amendments.

Pensions Regulator

The new Regulator will take over the existing functions of the Occupational Pensions Regulatory Authority and will have extensive new powers. The objectives of the Regulator were originally stated as being to root out fraud and bad governance. The government emphasised that the reforms should not increase the burdens on employers. However, the objectives of the Regulator are narrowly defined in the Bill to protect members' interests and reduce the risk of claims on the PPF.

With these objectives, it may be difficult for the Regulator to avoid effectively increasing the burden on employers by, for example, determining high contribution levels following referrals (see below) and encouraging trustees to require better funding levels.

The Regulator will have a number of new or extended powers. The most interesting of these are summarised in the table below.

Improvement notices	To require a person who has breached pensions legislation to prevent continuation/reoccurrence of that breach.
Third party notices	To require a third party to take specified measures to prevent continuation/recurrence of a breach by someone else. This is a potentially wide new power.
Freezing orders	Where consideration is being given to making an order to wind up a scheme, a freezing order can prevent contributions from being made and benefits from being paid (or can restrict benefits).
Application under section 423 (transaction defrauding creditors) of the Insolvency Act 1986	Where there is a deficit at the time of a qualifying insolvency event or the statutory funding objective is not being met (see below), the Regulator can apply to have any past transaction of an employer set aside. This could be a significant retrospective power in appropriate circumstances.
Gathering information	These will be extensive powers. Although well run schemes should have nothing to fear in principle, the requirement to admit inspectors, provide information and give interviews is bound to cause some cost and inconvenience.

Before exercising determinative powers, the Regulator will normally have to give affected parties an opportunity to make representations. However, where necessary, the Regulator can make a determination and hear from affected parties afterwards, in which case he can amend his determination before giving a final notice. There will be a new Pensions Regulator tribunal, which will be able to review determinations of the Regulator. There is an obvious move to improve consistency, as the structure and powers are very similar to other tribunals, including the Financial Services Authority tribunal.

The Regulator will be required to issue codes of practice which, although not binding, will be admissible in court. (Their status will be similar to the highway code.) It is intended that this will be a more flexible method of regulation than the current approach of detailed regulations covering a broad range of issues.

Pension Protection Fund

The much-heralded PPF will provide increased protection to members of underfunded schemes with insolvent employers. Much emphasis has been placed in the press and in the committee debates on the fact that the PPF will not be retrospective. Bearing in mind the cost of providing compensation, it is perhaps understandable that the PPF, which will not benefit from a government guarantee, will not compensate members of schemes where the employer experiences an insolvency event before the PPF is in place. It emerged during the committee debates that not only will protection not be retrospective but schemes may, at least in some circumstances, have to pay the PPF levy for three years before being eligible for protection. This uncertainty will create a dilemma for trustees who are considering winding up schemes but are holding off until protection is available.

Broadly, the PPF will become involved in a scheme if an insolvency event occurs in relation to the employer (see box) or if it appears to the trustees or the Regulator that the employer is likely to cease to continue as a going concern. There is no guidance as yet on how the trustees or Regulator should assess whether an employer is likely to continue as a going concern. In practice this will be very difficult. The committee debates seem to suggest that the intention was to include some flexibility where

employers may not be subject to UK insolvency proceedings eg because they are based overseas.

Insolvency

Insolvency will have a much wider meaning than it currently has for the purposes of determining whether the statutory debt that arises under section 75 of the Pensions Act 1995 should be calculated on an MFR basis or buyout basis. Currently 'insolvency' is determined by reference to whether the employer is in liquidation (whether insolvent or not). The new definition will include administration where the employer is insolvent but not members' voluntary liquidation where the employer is solvent.

After the PPF Board becomes involved, there is an assessment period during which it will determine whether to assume responsibility for the scheme, order the trustees to wind up the scheme or take no action. During this period, benefits will stop accruing, contributions will be suspended and benefits in payment will be reduced to the PPF protected level. The PPF Board will have wide powers to collect information, similar to those of the Regulator. They will share information. Many schemes that go into an assessment will have already been scrutinised by the Regulator. There will be a new PPF Ombudsman to review decisions of the PPF Board.

The key piece of information for the PPF Board will be a valuation (as at the date immediately preceding the insolvency event or the date of notification that the employer is unlikely to continue as a going concern) which will measure the funding level of the scheme's PPF protected liabilities (see box), presumably on a buyout basis.

Protected liabilities

Very broadly, the protected liabilities will be 100 per cent of pensions of pensioners (and others) above normal retirement date and 90 per cent of other pensions but subject to a compensation cap, expected to initially be about £25,000 pa at age 65. Apparently the rationale for limiting protection of active members to 90 per cent is to reduce 'moral hazard'.

Another key piece of information for the Board will be whether the insolvency practitioner advises that a 'scheme rescue' is possible. That term is key but is not yet defined. The committee debates suggest that it will involve the rescue or replacement of the employer.

If the valuation discloses a deficit of protected liabilities, the Board will take over the scheme. It will issue a

transfer notice transferring all the assets and liabilities from the trustees and then release the trustees. If the valuation does not disclose such a deficit, the Board will order the trustees to wind up the scheme unless a scheme rescue is possible. Assuming the priority order imposed on schemes is adjusted accordingly and suitable provision is made in the PPF valuation for expenses, the trustees should be able to buy out at least the protected benefits if such an order is made. Otherwise some members would be disadvantaged because the scheme had no deficit on the PPF valuation basis, but because of the priority order in section 73 of the Pensions Act 1995 and the scheme's trust deed and rules, members could receive less than their PPF protected benefits.

For schemes and employers that are not in financial difficulty, the impact of the PPF will be the new levies and the impact of the method of determining the risk based levy on funding (see below).

Trustees

Both the flexibility to set up alternative arrangements for member nominated trustees (MNTs) and the bureaucracy of complying with detailed statutory requirements will go. All schemes will be required to have at least one-third MNTs but there will be much less prescription in relation to the manner of their appointment.

The White Paper (June 2003) implied that a new statutory standard of care might be introduced along with express requirements for training. Instead the Bill

requires the following.

Trustees to be 'conversant' with:

- trust deed and rules;
- statement of investment principles;
- statement of funding principles (see below); and
- any written policy document.

Trustees to have 'knowledge and understanding' of:

- law relating to pensions and trusts;
- principles relating to funding and investment; and
- other matters that may be prescribed.

It seems that, where functions, eg investment functions, are delegated to a committee, the knowledge and understanding requirement will not apply to trustees who are not on the committee but this is not entirely clear. It will of course apply to all trustees where the committee does not have delegated authority but merely makes recommendations to the trustees.

It is not clear from the Bill who has the responsibility for ensuring compliance with these knowledge requirements. The trustee himself? The other trustees? The appointing person?

Funding

The MFR will finally go. However, it is not clear that the inflexibility and investment distortions will go with it. Schemes will be influenced by the test used to determine the PPF risk based levy and there will be a new balance of power between the trustee and employer which, although perhaps only subtly different for some schemes, could have surprising results depending on the approach the Regulator takes towards funding. The new funding provisions include the following.

Statutory funding objective	A statutory requirement for the scheme to have sufficient and appropriate assets to cover its 'technical provisions'. The wording is taken from the European occupational pensions directive with a view to ensuring compliance. However, the meaning is vague and use of the same words will not assure compliance.
Statement of funding principles	This will set out the methods and assumptions for calculating the scheme's technical provisions. It will have to be agreed between the trustees and the employer or be referred to the Regulator.
Schedule of contributions	A schedule showing the contributions of members and employers will need to be certified by the actuary as complying with the statement of funding principles and meeting the statutory funding objective. Employers and trustees will have to agree the rates (there will be no minimum) or refer the matter to the Regulator.
Statement of investment principles	As now, the trustees are responsible for this, having consulted with the employer.

Schemes where contributions above the MFR are regularly agreed between the trustees and employer could be forgiven for thinking that there should be little change in practice for them. However, this will depend on any codes of practice issued by the Regulator to help trustees with their negotiations and the approach the Regulator takes when matters are referred. As the Regulator's objectives are to protect members' interests and reduce claims on the PPF (see above), it is difficult to see how, in the absence of express guidance to the contrary, the Regulator and therefore trustees should not increasingly be seeking improved funding levels. This will be particularly true for schemes where the level of PPF protected benefits are a significant proportion of the scheme benefits.

Simplification

The Bill was intended to cover a number of simplification matters, including divorce and guaranteed minimum pensions. However, the only simplification measure of particular interest that remains is the change to section 67 of the Pensions Act 1995. This was introduced as an amendment to the Bill on 22 April.

The Bill will amend section 67 of the Pensions Act 1995 to introduce 10 new sections (67 to 67I). These will allow amendments that would or might adversely affect any subsisting right of any member or any survivor to be made if the actuary certifies that the actuarial value of members' benefits will not be reduced. The trustees will have to either make the amendment or consent to it. They will have to inform members before the amendment takes effect. Defined benefits cannot be converted to money purchase benefits and pensions in payment will not be able to be reduced unless the beneficiary consents in writing. The Bill also contains new provisions requiring employers to consult with employees on prescribed amendments (which, according to the committee debates should include winding up, closing the scheme and reducing future service benefits). Perhaps surprisingly, the validity of an amendment will not be affected by a failure to comply with the consultation obligations.

Employment issues

After extensive consultation on how pensions should be dealt with in the context of business transfers where old

age benefits are not protected by the Transfer of Undertakings (Protection of Employment) Regulations 1981 (Tupe), the government has included very simple provisions in the Bill. Where an employee has been in an occupational pension scheme before a transfer, a purchaser must provide either a money purchase scheme with matching employer contributions up to a prescribed level (probably 6 per cent) or a defined benefit scheme which satisfied the reference scheme test (used for contracting out purposes). Unlike other contractual terms, the new employer and employee will be able to agree alternative provision. This certainly has the apparent advantage of simplicity. However, with cases such as *Beckmann* and *Martin v South Bank University* telling us that only benefits that are old age benefits or survivors' benefits are exempt from Tupe (ie redundancy benefits and all benefits payable before normal retirement date do transfer), simplicity cannot be achieved.

The Bill also contains provisions for paid paternity and paid adoption leave to be treated in the same way as paid maternity leave ie employees contribute based on their actual pay but employers must contribute on the basis of salary employees would be paid if they worked normally.

Pension increases

Compulsory pension increases will reduce from 5 per cent limited price indexation (LPI) to 2.5 per cent LPI for benefits accrued after the effective date (probably 6 April 2005). This is perhaps a more reasonable requirement in times of low inflation. The government claims that it will offset some of the cost for the new PPF levies. However, many schemes will expressly have guaranteed increases of 5 per cent LPI which would have to be changed by agreement with the trustees (or members, see above). Further, this will be of little assistance to mature schemes with a high proportion of deferred members and pensioners.

For further information please contact

Ken Dierden
David Pollard
Catherine McAllister
T + 44 20 7936 4000
F + 44 20 7832 7001
E kenneth.dierden@freshfields.com
david.pollard@freshfields.com
catherine.mcallister@freshfields.com