



# The Pensions Bill 2004

The Pension Protection Fund



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## **Introduction**

The Pensions Bill was published on 12 February 2004. It sets out the detailed government proposals for significant changes to the regulation of pension schemes in the UK. These include:

- a new proactive Pensions Regulator (Regulator) to replace the Occupational Pensions Regulatory Authority (Opra);
- a Pension Protection Fund (PPF) to be established to provide members with a certain level of protection in the event of scheme insolvencies;
- abolition of the minimum funding requirement and replacement with a new scheme-specific funding requirement, to be agreed in respect of each individual scheme between the trustees and the employers; and
- simplifications in numerous areas, including member-nominated trustees and contracting out.

This guide looks at the proposals in the Pensions Bill 2004 to create the PPF, including amendments made during the earlier Standing Committee debates (up to 22 April 2004). Two other guides are available, on the Pensions Regulator and on other provisions of the Bill (trustees, funding, simplification and employment etc).

This guide considers three areas:

- the establishment of the Board of the PPF and its functions;
- how the PPF will operate – what schemes it will cover, how it will assume responsibility for a scheme and what benefits it will provide to members; and
- how the PPF will be funded – how the proposed levy on occupational pension schemes will operate.

## **Establishment and operation of the PPF**

The Board of the PPF is established as a body corporate by clause 81 of the Pensions Bill. The Pensions Bill provides that the Board is not to be regarded as a servant or agent of the Crown, or as enjoying any status, privilege or immunity of the Crown.

The Board's primary function is to 'hold, manage and apply' the PPF and the Fraud Compensation Fund.

- The Board may delegate any of its functions to any executive members of the Board, any staff member of the Board or any of the Board's committees or sub-committees.

### **Eligible schemes**

#### **Definition of eligible schemes**

The Pensions Bill envisages that the PPF will cover all 'eligible schemes'.

An eligible scheme is defined in clause 98 of the Bill as an occupational pension scheme which:

- is not a money purchase scheme;
- is not a prescribed scheme or a scheme of a prescribed description; and
- is not being wound up immediately before a prescribed date (to be determined by the Secretary of State).

The PPF would not, therefore, apply retrospectively to schemes already being wound up or where winding-up has been completed.

The explanatory notes to the Bill suggest that the schemes which will, by regulation, be prescribed as *not* being eligible schemes will mainly be those schemes which are currently exempted from the application of the minimum funding requirement under regulation 28 of the Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuations) Regulations 1996. These include unfunded public service pension schemes, schemes which have a ministerial guarantee, unapproved schemes and schemes with fewer than two members.

The notes also suggest that regulations may modify this definition for hybrid and multi-employer schemes.

#### **Issues raised**

Unsurprisingly, the key issue raised in debate in the House of Commons Standing Committee considering the Bill (Standing Committee) on this clause is whether the PPF should apply retrospectively. MPs pointed to numerous recent high-profile cases

(including ASW) where, as a result of company insolvencies, pension schemes are being wound up in deficit and members are receiving only a small proportion of their expected benefits.

For example, Kevin Brennan (Cardiff West, Labour) said:

‘I walked into a meeting of steelworkers in Cardiff in the Railway club in Splott a couple of years ago and met workers who had faced a double whammy. They had lost their jobs and were likely to lose their pensions. I thought that such an experience might have been possible in the Dickensian era in this country... But I discovered that it was possible for it to happen in the 21st century, despite the fact that only a few years previously there had been legislation on the matter’.

Amendments were proposed to clause 98 which would:

- extend the coverage of the PPF to schemes which are already winding up at the date specified by the Secretary of State; and
- extend the coverage of the PPF to schemes where winding-up had been completed by that date.

It seems that the amendments were proposed (by both Conservative and backbench Labour MPs) on a speculative basis to elicit commitment from the government to deal with the retrospectivity problem. The Standing Committee voted against these amendments and the government agreed to ‘listen to and study all serious suggestions for a way forward’.

In more recent interviews, the government appears to be indicating that some form of compensation (outside the PPF) may be made available to such scheme members.

#### **How the PPF becomes responsible for eligible schemes**

The process whereby the PPF becomes responsible for an eligible scheme is complex. Appendix A summarises the process and the relevant clauses at each stage.

The key issues are as follows.

- What triggers the PPF’s involvement?
- What is the effect of the PPF becoming involved?
- When will the PPF assume responsibility?
- What happens if the PPF does not assume responsibility?

#### **Events triggering the PPF’s involvement**

Three key events trigger the PPF’s involvement in a scheme.

- A ‘qualifying insolvency event’ occurring in respect of an employer (clause 99(1)).
- An application by the trustees/managers of a scheme (clause 101(1)).
- Notification by the Regulator (clause 101(4)).

**Qualifying insolvency event**

A qualifying insolvency event is defined in clause 99(3)(a) as an insolvency event which does not fall within an assessment period in respect of a scheme – ie where the PPF is already considering whether to take responsibility for the scheme under a different provision.

Insolvency event is widely defined in clause 95 of the Pensions Bill. It includes the winding-up of a company (save for situations where a resolution is passed for the voluntary winding-up of a solvent company) and other statutory insolvency procedures (such as administration).

The government has proposed amendments to the definition of qualifying insolvency event<sup>1</sup> at the Standing Committee stage which would clarify that the qualifying insolvency event must:

- occur on or after the date appointed by the Secretary of State;
- be the first insolvency event to occur in relation to that employer on or after that day; and
- not be an insolvency event that occurs in prescribed circumstances.

The intention of these amendments was explained by the Pensions Minister, Malcolm Wicks, in Standing Committee:

‘[The amendment] would add further provision setting out that any insolvency event that occurs in relation to a scheme is only a qualifying event for the purpose of entry into the PPF if it occurs after the day the PPF starts operating... The amendment further ensures that scheme trustees will not be able to manipulate their situation in the run up to PPF to gain entry. Without amendment, a company could go bust today, but if the trustees could prevaricate long enough and delay commencing winding up the pension scheme, the PPF could be liable to pay compensation’.

In addition, this definition means that situations where the trustees have entered into *Bradstock* style compromise agreements with the employer (ie where the trustees agree to compromise the debts owed to the pension scheme to avoid insolvency of the employer) would not fall within clause 99.

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<sup>1</sup> Proposed new clause 99(2A).

John Robertson (Labour) moved an amendment that would have brought such compromises within the scope of clause 99. He was concerned that, instead of using compromise agreements to maximise return for members, trustees might instead seek to push employers into insolvency to fall within the PPF regime.

Malcolm Wicks understood these concerns and had sympathy with them but was concerned that unscrupulous employers would offer schemes low amounts of money by way of compromise, knowing that the PPF would be there to pick up the pieces. As a result the amendment was withdrawn, although Mr Wicks did confirm that he and the Department for Work and Pensions (DWP) intended to reflect further on this question.

This may mean that the only potential method of reaching a compromise in future on a company's liabilities to a scheme without the employer becoming insolvent would be if the employer entered into a specific insolvency arrangement (eg a scheme of arrangement) to reach a compromise agreement with the PPF.

Where an insolvency event has occurred, the appointed insolvency practitioner must give notice as soon as practicable:

- that a scheme rescue is not possible;
- that a scheme rescue has occurred; or
- in prescribed circumstances, where insolvency proceedings in relation to the employer are stayed or have come to an end, or a prescribed event occurs, that he cannot confirm whether a scheme rescue is possible or that a scheme rescue has occurred.

The notice should be given to the PPF, the Regulator and the trustees of the pension scheme. Regulations will give more details on the time limits for such notification and the content of the notice.

**Application by the trustees/managers of a scheme**

Clause 101(1) *requires* the trustees of an eligible scheme to make an application to the PPF for it to assume responsibility for the scheme if the trustees believe the employer is unlikely to continue as a going concern (and prescribed requirements are met regarding the employer).

It is difficult to see how trustees would assess whether an employer would be likely to continue as a going concern. The trustees may not have access to the relevant financial information about the company and, even if they do, they may not have the necessary expertise to assess the financial strength of the company.

Interestingly, this point was raised in Standing Committee by Nigel Waterson (Conservative), who suggested that it might be better to ‘give trustees the power to make an application, so that they have the power, but not necessarily an obligation’<sup>2</sup>. In response, Malcolm Wicks commented that this obligation would be limited to a minority of schemes because it was aimed at those where the employer was not subject to insolvency events as defined in UK legislation (such as where there is an overseas sponsoring employer). As the clause does not limit its application to this type of scheme the regulations setting out the ‘prescribed circumstances’ when this type of application must be made may include these limitations.

The Standing Committee has proposed to amend this provision so that the duty to apply arises if the trustee *becomes aware* that the employer is unlikely to continue as a going concern<sup>3</sup>.

The inclusion of this duty may lead to further difficulties for trustees who are also on the employer’s management team. Such trustees may have access to more information about the financial situation of the company and may find themselves in a difficult position if they are aware (in their management capacity) of facts which would justify an application to the PPF<sup>4</sup>.

#### **Notification by the Regulator**

Clause 101(4) provides for a similar duty on the Regulator to notify the PPF if it becomes aware that the employer is unlikely to continue as a going concern.

#### **The effect of the PPF becoming involved**

A triggering event under clauses 99 or 101 leads to the commencement of an assessment period in relation to the scheme (clause 104).

#### **Effect of assessment period**

The Bill sets out detailed provisions on the effect of a scheme of being in an assessment period (in clauses 105 to 111), summarised here.

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<sup>2</sup> Alternatively, he noted that the National Association of Pension Funds (NAPF) has suggested that the Regulator could issue guidance to trustees on how to discharge their responsibilities.

<sup>3</sup> This could arguably impose a more passive (and so more limited) duty on the trustees than the existing wording. An alternative argument is that it makes no real difference.

<sup>4</sup> It is not clear whether a trustee with this knowledge has a duty to make the application to the PPF. The clause refers to the ‘trustees’ (plural) rather than any single trustee.

The scheme is subject to restrictions (set out in clause 105), including the following:

- no new members are to be admitted (clause 105(2));
- no further contributions are to be paid (although these contributions may become payable if the PPF ceases to become involved in the scheme (clause 118);
- no benefits are to accrue (clause 105(6)) save for normal increases to benefits<sup>5</sup>; and
- no transfer payments are to be made except in prescribed circumstances (clause 105(5)).

The PPF can give directions in relation to the scheme (clause 106):

- to a 'relevant person' ie trustees, managers, employers and other prescribed persons; and
- regarding the exercise of powers, including investment, expenditure, conduct of legal proceedings and other prescribed matters.

The scheme cannot commence winding up (clause 107). Any action to wind up is void unless the PPF validates the decision (under the procedure in clause 108). There is an exception for a winding-up directed by the Regulator (clause 107(3)).

Rights and powers in relation to debts owed by the employer (eg under section 75 Pensions Act 1995) are exercisable by the PPF and not the trustees (clause 109):

- if amounts are paid to the PPF, it must pay the amounts to the trustees; and
- the PPF is not bound by any insolvency arrangement<sup>6</sup> which relates to a debt under section 75 of the Pensions Act 1995 (unless it consents).

Presumably any future Bradstock compromises would have to be negotiated by the PPF following a triggering insolvency event – the PPF should have power to reach a compromise in the same way as the trustees of the scheme (as all rights and powers of trustees regarding the debt are vested in the PPF)<sup>7</sup>.

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<sup>5</sup> And money purchase accrual which is solely return on investments already held (clause 105(8)).

<sup>6</sup> Which is defined to include a voluntary arrangement under part 1 or 8 of the Insolvency Act 1986 and a scheme of arrangement under section 425 Companies Act 1985 (clause 109(6)).

<sup>7</sup> Chris Pond (Parliamentary Under-Secretary of State, DWP) confirmed in the Standing Committee debates that clause 109 was intended to include the PPF

Payments to members must be reduced (clause 110):

- to the extent necessary to ensure that the benefits do not exceed the compensation which would be payable if the PPF took on responsibility for the scheme ie the benefits in schedule 7;
- this excludes money purchase benefits; and
- regulations may provide that, in prescribed circumstances, the commencement of a member's pension may be postponed if the member continues in employment after normal pension age<sup>8</sup>.

The PPF can lend money to trustees to enable them to pay benefits (clause 111):

- if satisfied that the trustees are not able to pay the (reduced) benefits as they fall due and the trustees make an application to the PPF; and
- the PPF will charge interest on the loan at a prescribed rate and the trustees will be liable to repay the loan if the PPF ceases to be involved in the scheme.

#### **Valuation**

Under clause 112, the PPF is required to obtain a valuation to assess whether the assets of the scheme are less than its protected liabilities – see clause 99(2)(a) and clause 100(2)(b).

'Protected liability' is defined in clause 103 and is the total of:

- the cost of securing benefits for and in respect of members of the scheme which are equivalent to the compensation which would be paid to members (under schedule 7) if the PPF assumed responsibility for the scheme; plus
- other liabilities of the scheme (ie not to members)<sup>9</sup>; plus
- the estimated cost of winding-up.

The calculation is made as at the 'relevant time'. This is defined in clause 112(3) as follows:

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having the ability to reach a *Bradstock* compromise (see Standing Committee 25 March 2004, pm, column number 462).

<sup>8</sup> 'Continues in employment' does not require the member to continue in employment with the same employer. 'Normal pension age' is defined for the purposes of schedule 7 (paragraph 31) as 'the age specified in the admissible rules as the earliest age at which the [benefit] becomes payable without actuarial adjustment [disregarding special scheme rules for ill-health]'.

<sup>9</sup> For example outstanding investment management fees and legal fees.

- where the trigger event is a qualifying insolvency event (under clause 99), the relevant time is immediately before the insolvency event; and
- where the trigger event is a notification/application (under clause 101), the relevant time is the time immediately before the application was made or notice received (clause 100(3)).

**Approval of valuation**

If the PPF is satisfied that it has obtained a valuation which complies with the requirements of clause 112, then (under clause 113) it must approve the valuation and provide copies to the Regulator, the trustees and the insolvency practitioner (or the employer). If the PPF is not satisfied that the valuation complies with clause 112, it must obtain another valuation (clause 113(3)).

Once the valuation has been approved, it does not become binding until the period in which the approval can be reviewed by the PPF Ombudsman has expired or any such review has been finally determined (clause 114).

When the valuation becomes binding, the PPF must give notice to the trustees and the insolvency practitioner or employer (clause 114(3)).

**When will the PPF assume responsibility for a scheme?**

The PPF will then need to consider whether it must refuse to accept responsibility for the scheme under the provisions of the Pensions Bill. If it does not refuse, it will assume responsibility for the scheme.

It must refuse responsibility in a number of situations.

- Where the valuation determines that the scheme has sufficient assets to meet its protected liabilities (clause 99(2)(a) and clause 100(2)(a)).
- Where the scheme was not an eligible scheme ‘throughout such period as may be prescribed’ (clause 115). Chris Pond (Labour) gave an indication of the government’s intentions, explaining that:

‘The intention is that a scheme will be required to have been an eligible scheme, and thus to have paid the levy, *for three years* in order to be taken over by the PPF. When a scheme has been established for less than three years, in order to be taken over by the PPF it will have to have been an eligible scheme from the date of entitlement to the date of the insolvency event, or clause 101 application or notification’<sup>10</sup>.

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<sup>10</sup> This clause and clause 116 (new schemes) are described as the ‘moral hazard’ clauses in Standing Committee debate.

- Where the scheme is a ‘new scheme’ (clause 116). This is a scheme:
  - established during a prescribed period;
  - with the same employer as another scheme (the ‘old’ scheme);
  - which has received a transfer payment from the old scheme; and
 these procedures have been carried out principally to enable the new scheme to benefit from the PPF in circumstances where the old scheme would not have done so because of clause 116<sup>11</sup>.
- Where a scheme rescue has been achieved and this is confirmed either by the insolvency practitioner to the employer under clause 96(2) or by the PPF following an application or notice under clause 101 (clause 117). There is no definition of scheme rescue yet.
- Where a scheme rescue is not possible but the PPF is satisfied that no insolvency event has occurred or is likely to occur (during the period of six months from the date of the notice) (clause 117(4) and (5)).

**What happens if the PPF refuses to accept responsibility for a scheme?**

**If scheme has sufficient assets to meet protected liabilities**

If the PPF does not accept responsibility because the scheme has sufficient assets to meet its protected liabilities (and no scheme rescue is possible), the scheme trustees can make an application for reconsideration under clause 120. That application:

- must be made within a prescribed period and in the prescribed form; and
- must be accompanied by a ‘protected benefits quotation’ and an auditor’s valuation in relation to the scheme.

A protected benefits quotation is a quotation in relation to the scheme for the purchase of annuities in respect of each member of the scheme of (i) benefits equal to the schedule 7 benefits or (ii) benefits equal to their accrued benefits in the scheme (whichever could be secured at lower cost)<sup>12</sup>.

If the PPF is satisfied that the value of the scheme’s assets is less than the aggregate of the amount stated in the protected benefits quotation, the other liabilities of the scheme (ie to non-members)

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<sup>11</sup> This is an anti-abuse provision. The explanatory notes (paragraph 256) explain that it is intended to prevent abuse whereby schemes are set up to avoid paying the levy, a new scheme is then established and existing members are transferred to the new scheme when insolvency seems likely.

<sup>12</sup> At the Standing Committee stage, the government has proposed further new clauses which would cover the situation where a scheme in this situation (eg a very large scheme) was unable to obtain a protected benefits quotation because of insufficient capacity in the insurance market (see Standing Committee 25 March 2004, pm, column 457/458).

and the estimated costs of winding up the scheme, it must assume responsibility for the scheme (clause 121)<sup>13</sup>.

If it is not, clause 119 applies. This provides that (following the period for any reference to the PPF Ombudsman), the trustees are *required* to wind up the scheme:

- winding-up is deemed to begin immediately before the assessment period (clause 119(6));
- winding-up occurs regardless of any rule of law or rule in the scheme to the contrary (including any consent requirements) clause (119(9)); and
- the PPF may give directions to the trustees on the winding-up of the scheme (clause 119(7)).

In practice, this seems like a harsh requirement. However, the extent to which it is triggered will depend largely on what the requirements are for a scheme rescue – as the winding-up would not be triggered in that situation. In addition, the government has proposed amendments to the Pension Bill to protect schemes which are not able to obtain a protected benefits quotation (for example, because the value of annuities that they are trying to secure is too large for the annuity market).

Where a winding-up is triggered, the winding-up priority order will be important. Presumably, the protected liabilities will need to have priority over other scheme liabilities. If not, then the members may not receive their ‘protected’ PPF benefits (eg because there are a large number of high value pensioners who would have been capped under the PPF but are not capped under the current section 73 of the Pensions Act 1995)<sup>14</sup>.

#### **In other cases**

In other cases where the PPF refuses to take responsibility for a scheme, it issues a withdrawal notice to the Regulator, trustees and insolvency practitioner/employer and its involvement in the scheme ceases (and the assessment period ends).

Under clause 118, consequences of the PPF ceasing to be involved in a scheme are as follows:

- the amounts of any benefits which were not paid as a result of clause 110 (reduction of benefits to schedule 7 levels) fall due; and

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<sup>13</sup> The PPF may obtain its own valuation of assets (clause 121(3)) – but appears to be bound by the protected benefits quotation obtained by the trustees.

<sup>14</sup> Malcolm Wicks indicated in Standing Committee that the government’s proposals on priority order should be introduced to the Committee after Easter and will be part of the Bill.

- regulations may provide that benefits accrue to members which would have accrued but for clause 105(6) (Benefits not to accrue during assessment period).

#### **Consequences of board assuming responsibility**

There are three issues to consider here: how the PPF assumes responsibility, the effect of this, and the benefits payable by the PPF.

#### **How the PPF assumes responsibility**

If the PPF assumes responsibility for the scheme, then it is required to issue a transfer notice under clause 122. This must be issued to the trustees, with copies sent to the Regulator and to the insolvency practitioner/employer.

#### **Effect of the PPF assuming responsibility**

Clause 123 provides that where a transfer notice is given to the trustees of an eligible scheme, the Board of the PPF assumes responsibility for the scheme. This has the following effects.

- The property, rights and liabilities of the scheme are transferred to the PPF. Liabilities are defined to exclude 'liability to, or in respect of, any member of the scheme, other than liabilities in respect of money purchase benefits'. This is presumably an error (although it does not appear to have been picked up at the Standing Committee stage), as it results in the PPF taking on only money purchase liabilities.
- Schedule 6 sets out further provisions on the transfer to the PPF to ensure that the Board of the PPF gets the benefit of all property of the scheme. For example, schedule 6 provides that:
  - property rights and liabilities transfer even if they would not otherwise be capable of transfer;
  - any legal proceedings can be continued by the Board of the PPF;
  - the transfer takes place regardless of any requirement for a party to consent;
  - references to the trustees in documents are regarded as references to the Board of the PPF (so far as necessary to affect the transfer); and
  - no person can terminate or modify any interest or right which is vested in the trustee in consequence of the transfer.
- Schedule 6 also provides that if any contract of employment would transfer to the Board of the PPF the contract is terminated on the day preceding the day on which the transfer notice is received by the trustee. The Standing Committee noted that any employment claims arising out of such termination (eg for unfair dismissal) should transfer to the PPF.

- The trustees are discharged from their pension obligations. This discharge is limited to ‘pension obligations’, which will mean that the trustees remain personally liable in other respects<sup>15</sup> but may no longer have the benefit of any indemnity out of the fund (or effectively the employer, if it is insolvent). The Standing Committee discussed this, including potentially including an indemnity from the PPF in favour of trustees for other liabilities. However, it reached the view that ‘Prudent trustees should as a matter of course have indemnity insurance in respect of personal liabilities’ and so the amendment was unnecessary.
- Schedule 6 (paragraph 3) provides that liabilities do not transfer to the Board of the PPF where they are against the trustees and the trustees would have been personally liable and not have been indemnified out of the assets of the scheme.
- The Board of the PPF must notify the Inland Revenue if the effect of the discharge is to discharge the trustees from their liability to provide guaranteed minimum pensions (clause 127).
- The scheme is treated as winding up immediately after the transfer of liabilities (clause 123(2)). Presumably the winding-up would trigger a section 75 debt (if it has not already been triggered) and the ability to enforce that debt would transfer to the PPF (as a right of the scheme).
- The PPF Board is required to pay pension compensation to members (under provisions in Schedule 7) (clause 124) as follows:
  - regulations may provide that the PPF can postpone compensation to a member for a period in which he continues in employment after normal pension age;
  - the PPF must pay any unpaid benefits relating to the period before the assessment date (clause 128); and
  - regulations may prescribe various matters relating to compensation payments, for example the manner and time when compensation is paid, for recovery of overpayments and total commutation (clause 130).

**Benefits payable by the PPF under schedule 7**

The provisions of schedule 7 are complex and this is only a brief summary. The effect on different categories of members is summarised in Appendix B.

The broad approach appears to be that the PPF will replicate some scheme-specific characteristics (ie base compensation on the rules of the scheme) for a member’s basic benefit. However, the PPF is not

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<sup>15</sup> For example, for any acts or omissions, breaches of trust etc prior to the transfer notice.

intended to replicate all of a member's rights and benefits under the scheme. On those issues, the government has taken a 'broad brush' approach which is considered to be 'equitable and... simpler to administer'.

- Pensioners (over normal retirement age (NRA)/retired due to 'ill-health' (to be defined)) and deferred members who are past normal retirement age (at the date of assessment) are entitled to compensation of 100 per cent of their benefit calculated in accordance with the 'admissible rules' of their scheme.
- Active/deferred members who are not past normal retirement date (at the date of assessment) are entitled to compensation of 90 per cent of their accrued benefit (calculated in accordance with their accrual rate, pensionable earnings and pensionable service under the admissible rules of the scheme).
- In both cases, a spouse pension is provided of 50 per cent of the benefit to which the member was entitled. The spouses pension appears to be payable even where such a benefit was not provided under scheme rules<sup>16</sup>.
- Schedule 7 sets out the rates of increases which apply (rather than the increases in the scheme rules applying). LPI increases will apply to post-1997 benefits.
- Regulations may provide for compensation to be made to prescribed dependants (paragraph 22).

'Admissible rules' has been defined to exclude recent rule changes if those rule changes and recent discretionary increases have a combined effect to increase the protected liabilities under the scheme (paragraph 32(3) and (3A)). 'Recent rule changes' means changes which were made or took effect in the three years before the assessment date and any scheme rules which are triggered by the winding-up of the scheme or insolvency of the employer. 'Recent discretionary increases' are increases which came into effect in the three years before the assessment date.

#### **Limitations on the compensation payable**

##### **Compensation cap**

Amounts payable to a member will be subject to a compensation cap. This is set out in paragraph 25 of schedule 7 (which has been replaced entirely by the Standing Committee as a result of the government's proposed amendment).

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<sup>16</sup> The debate on this at Standing Committee assumes that all schemes will be contracted out and will therefore provide a spouse pension. However, it is pointed out that the broad brush approach may lead to inequities – eg a scheme may provide a lower accrual rate but have better spouse benefits.

The amount of the compensation cap is to be set by the Secretary of State (and can be adjusted by the Board of the PPF according to actuarial factors published by it for members who start to take their benefit before age 65 or after age 65). The amount of the cap is to increase in line with earnings. The working assumption is that the cap will be set at £25,000 per annum.

**Powers to reduce benefits payable**

Clause 30 of schedule 7 includes a wide power for the Secretary of State, on recommendation from the Board of the PPF, to:

- change the percentages specified to calculate benefits (ie the 100 per cent and 90 per cent above);
- reduce the revaluation rate for deferred benefits; and
- reduce the level of pension increases.

Such an order may have effect:

- for a specified limited period;
- in respect of all payments under the PPF; and
- in respect only of persons who become entitled to compensation payments after a specified date.

Unsurprisingly, this has been a controversial provision. In Standing Committee debate, the key concern was that the PPF is being sold to the public as an insurance policy for pensions, but in fact this wide power means that benefits could be substantially reduced. One MP asked what good rainy-day insurance is that says, 'Well, here's your insurance for a rainy day but if it rains really hard we will not pay out'?

This type of provision is clearly necessary unless the PPF were underwritten by government (to date vetoed by the government, which argues that the power is to be used only in the most extreme circumstances).

## Funding of the PPF

One of the key issues which has made the headlines is how the PPF is to be funded. Getting the funding right is crucial, as the PPF's success will depend on whether it has enough money to effectively underwrite the schemes it is designed to support.

There is to be no official government guarantee of the PPF but many commentators have argued that there is, in effect, an unwritten political guarantee. If the PPF were ever to default, the public outcry would be significant and people would look to the government to bail it out.

Peter Atkins of the DWP's policy unit clearly envisages that government support for the PPF is imperative, commenting that 'if we come to a situation where there was not enough money in the fund... it would mean systematic failure [of pensions] and then all bets would be off'.

The US model for the PPF, the Pensions Benefit Guarantee Corporation (PBGC), has no government guarantee either and has operated with a substantial deficit.

The Pensions Bill provides that the funding of the PPF will come from a number of sources, the most significant of which are:

- the scheme levy (an initial levy for up to the first two years moving to a flat rate levy and/or a risk-based levy);
- an administration levy;
- assets from schemes for which the PPF assumes responsibility;
- investment income or capital gain arising from the PPF's assets;
- money borrowed by the PPF under clause 89 and grants under clause 90; and
- amounts transferred from the Fraud Compensation Fund.

There is also a fraud compensation levy which will only apply where cases of fraud arise.

The PPF will, of course, have a number of different types of expenditure. Clause 135(3) provides an exhaustive list of the items that are payable from the PPF. The most significant are the sums required to discharge the liabilities for which the PPF has assumed responsibility. There are also other matters such as sums required to pay any unpaid scheme benefits (as provided for under clause 138 of the Pensions Bill) and sums required to make payments under clause 125(3)(b) (underpayments during the assessment period).

### Overview of the levy

For an initial period of probably a year before the main levy is introduced, there will be an initial levy at a flat rate for all schemes. This is expected to raise about half the annual amount required to fund the PPF. The initial period is to allow time to collect data needed to calculate the risk-based levy.

The main levy which will be phased in following the initial period will comprise two elements:

- the scheme-based levy; and
- the risk-based levy.

The scheme-based element will be based on the number of members, the total annual pensionable earnings of actives, the amount of scheme liabilities in respect of members and 'such other factors as may be prescribed' in regulations.

The risk-based element must comprise at least half of the total levy. There was some debate on the 50 per cent requirement in Standing Committee and an amendment (supported by the NAPF) was proposed to raise the minimum level to 75 per cent. The Pensions Minister explained that although the ultimate aim was for about 80 per cent of the levy to be raised from the risk-based element, the government did not want to be too prescriptive and wanted the PPF to have sufficient flexibility to set the rates. By way of contrast, the PBGC sources only about 25 per cent of its funds from the additional risk-based element.

The risk-based levy will broadly be assessed by reference to the difference between the value of a scheme's assets and its protected liabilities and, if the PPF considers it appropriate, certain other risk factors. These other risk factors are as follows.

- The likelihood of an insolvency event occurring in relation to the employer. As this is the real trigger for the PPF involvement, and not underfunding in itself, an amendment was debated in Standing Committee which would elevate this to a factor that the PPF *must* take into account rather than one it may take into account, but this was withdrawn after debate. In particular, the difficulty in measuring credit risk was highlighted. It is interesting to note that the PBGC takes no account of creditworthiness, only underfunding.
- The risks associated with the nature of the scheme's investments when compared to the nature of its liabilities.
- 'Such other factors as may be prescribed.'

At the beginning of each financial year, the PPF must determine a number of issues regarding the levy, including whether to impose

both the risk and the scheme-based levy, the factors by reference to which the levy is to be assessed, the rate of the levy and the timing of payments.

The levy is payable by trustees and recoverable as a debt due to the PPF. Regulations will detail the collection and recovery of amounts payable in respect of the levy.

The Standing Committee discussed the possibility of employers recovering at least the scheme-based element of the levy from scheme members. It was thought that employers had the flexibility to pass on the cost if they so wished, although there are of course problems in collecting the fee from deferred and pensioner members.

### **The initial period**

There were concerns that the risk-based element of the levy might delay the April 2005 start date for the PPF because all the data needed to calculate it is not yet available. An initial levy at a flat rate for all schemes will therefore apply for at least the first year during the phased introduction of the main levy. The initial levy is expected to recover half the amount required to fund the PPF. The Bill provides that the initial levy can be extended for a second year. Regulations will provide more details, including the factors by reference to which the initial levy is to be assessed and the actual rate of the levy.

During the initial period, the government has indicated that the levy is likely to be approximately £10 per member (ie actives, deferreds and pensioners). An amendment (backed by the NAPF) to limit the flat rate element to £5 per member was tabled in Standing Committee, but rejected. The argument for limiting the scheme-based element is that schemes which have a large number of low-paid or part-time workers are disproportionately affected by the levy compared to schemes which have more highly paid workers.

There was lengthy discussion (and a vote) in Standing Committee on whether there should be an initial levy at all. A proposal was made to limit the initial period to 12 months rather than allowing the possible extension for another year. This was because of concerns that if the initial levy was raising only half of what was required for the first year, this should not be allowed to continue beyond the first year. Due to the potential for well-funded schemes to effectively subsidise poorly funded schemes while a flat-rate levy is applied, it was even suggested that this might encourage some employers to move away from final salary scheme provision altogether.

### **The transitional period**

The second phase of the introduction of the levy will comprise a transitional period (expected to last up to April 2009) to allow schemes to carry out a valuation for assessing the level of their risk-based premium. The Pensions Bill envisages regulations which will require trustees to provide the PPF with actuarial valuations at certain intervals (to be determined by regulations). The regulations will also prescribe how assets and protected liabilities are to be determined, calculated and verified in accordance with guidance from the PPF. The government expects these PPF-required valuations will fit with normal valuation cycles.

The scheme-based levy will apply until a scheme's valuation for this purpose is published and the government has indicated that schemes will be able to choose when to move to the risk-based premium 'as best fits the normal triennial valuation cycle'. Although no limit is placed on the transitional period in the Pensions Bill, the Pensions Minister acknowledged in Standing Committee that the transitional period must last for one year longer than the three-year valuation cycle to allow for the usual delay of up to one year in publishing a valuation. Therefore, assuming the initial period lasts for one year, all schemes should have moved to the full levy by 2009.

The DWP Pension Factsheet published with the Pensions Bill confirms the government's intention that the risk-based levy will be phased in and notes:

'Well run schemes will not lose out as the Pension Protection levy will be set to raise just half what the levy will raise in later years. We will be enabling the Board to introduce a risk-based component from the second year so that the risk-related factors can be added in in the way that suits schemes best. If they think it is in their interests to have an early valuation done, then they can do this as soon as they like; alternatively they can wait until their next tri-annual valuation is completed. So, schemes face a low levy in the first year and the flexibility to move towards a more risk-based system as it suits them'.

The government has promised that the PPF will consult closely with businesses in developing the levy and that it will publish the detail within the first year of operation. It has also indicated that the average scheme-based levy during this period is likely to average approximately £20 per member. The total levy raised by the PPF cannot exceed the levy ceiling set by the Secretary of State. The government has indicated this is likely to be around £300m in the first year (and possibly £600m thereafter).

The government has said that estimates on the amount that the levy would need to raise will be based on actuarial modelling of PPF finances over the next 20 years given a range of assumptions about several factors, including pension scheme funding levels and rates of insolvency. The current target figure is about £300m per year (with 80 per cent of the total derived from a risk-factor based levy), which, according to the government, ‘involves some rather gloomy assumptions’, including the risk of several insolvencies in the largest FTSE companies over that period. However, there will always be a doubt about whether the assumptions are sufficiently ‘gloomy’. The PBGC, for example, found that pension claims during 2002 were greater than the total claims for all previous years combined<sup>17</sup>. Much of this was due to the failure of a significant number of large companies with highly underfunded plans and, of course, the same could happen here.

The Pensions Bill 2004 Regulatory Impact Assessment suggests the following structure for the levy (based only on allowing for underfunding but noting that when the PPF is able to implement the levy procedures in full it will include other risk factors).

| <b>Funding level relative to PPF level of compensation</b> | <b>Levy/premium</b>   |
|--|---|
| Over 100 per cent funded                                   | Scheme factor levy only.  |
| Between 80 per cent and 100 per cent funded                | Scheme factor rate levy; risk-based levy of £4 per £1,000 of underfunding.  |
| Under 80 per cent funded                                   | Scheme factor rate levy; risk-based levy of £4 per £1,000 of underfunding for first 20 per cent of underfunding, plus £8 per £1,000 of underfunding for the rest of the underfunding. |

Once a scheme’s valuation is published, the risk-based levy (if appropriate) and a lower scheme-based levy will apply. Well-funded schemes are likely to want to trigger the risk-based element as early as possible so that they can pay a lower levy. A scheme which is over 100 per cent funded in respect of its protected liabilities will only pay a scheme factor levy and the government has indicated this is likely to be around £4 per member.

Conversely, as the moral hazard in a levy without a risk-based element is that there is no incentive for poorly performing companies to fund their schemes, giving schemes flexibility in adopting the risk-based levy offers underfunded schemes (which are the ones the risk-based levy is designed to target) the opportunity to

<sup>17</sup> According to Steven Kandarian in ‘Pension Insurance in the United States’, *PMI News*, November 2003.

delay as long as possible. An MP gave the analogy of a 'boy-racer' versus the 'staid middle aged driver' who would both be paying the same level of insurance and pointed out that it was a 'wacky sort of insurance scheme, where the bad risk as well as the good risk can pay low premiums'. In addition, he noted that a big solvent company that works hard to fully fund its liabilities can opt for the risk-based premium quickly and presumably pay not very much, while a 'dodgy company' that has not funded its scheme properly and is probably teetering on the brink of insolvency can defer moving to the risk-based premium.

It is well recognised that the PBGC came into difficulties at the start because it charged only a flat-rate levy for the first four or five years.

### **The full regime**

After the transitional period ends, at the start of each year the PPF must estimate the amount which will be raised by the levies it proposes to impose.

This amount will be subject to the levy ceiling which is set by the Secretary of State in a statutory instrument before the start of each financial year. It will usually be the amount set as the levy ceiling for the previous year increased in line with earnings (and a discretion is given to the Secretary of State to estimate such increase in earnings). The Secretary of State can raise the ceiling by more than the earnings percentage on the recommendation of the PPF and with the consent of the Treasury.

There are provisions in the Bill for regulations to set a lower levy ceiling for the first year after the transitional period.

In addition to the ultimate cap provided by the levy ceiling, the PPF itself cannot increase the levy (both scheme- and risk-based elements) to raise more than 25 per cent of the total raised in the previous year.

The importance of the levy ceiling will depend on the relative amounts of the levy ceiling in the first year (probably 2010) and the actual total raised by the levy in that year. If there is a large difference, the constraint of the 25 per cent increase limit will mean that it will be many years (if at all) before the PPF can set a figure anywhere near the levy ceiling. If, however, the two figures are close and a 25 per cent increase is applied each year, it will not take long for the amount the PPF wishes to set to reach the ceiling (which is only likely to be increased in line with earnings rather than 25 per cent each year).

A further limit on the levy is that if the PPF imposes both a scheme-based and a risk-based levy, at least half of the levy must come from

the risk-based element (to address the criticism that any levy on all schemes is unfair on well-funded schemes as they will, effectively, be subsidising the poorly-funded schemes). In addition, the PPF can decide to set only the scheme levy if the amount it expects to raise in a year is less than 10 per cent of the levy ceiling for that year.

#### **Issues arising from the risk-based levy concept**

Concerns were raised in parliament that the risk-based levy may take account of a sponsoring employer's credit rating: the analysis might become somewhat circular with markets waiting for the PPF to list which schemes should pay the highest risk-based levy and then giving the relevant companies low credit ratings.

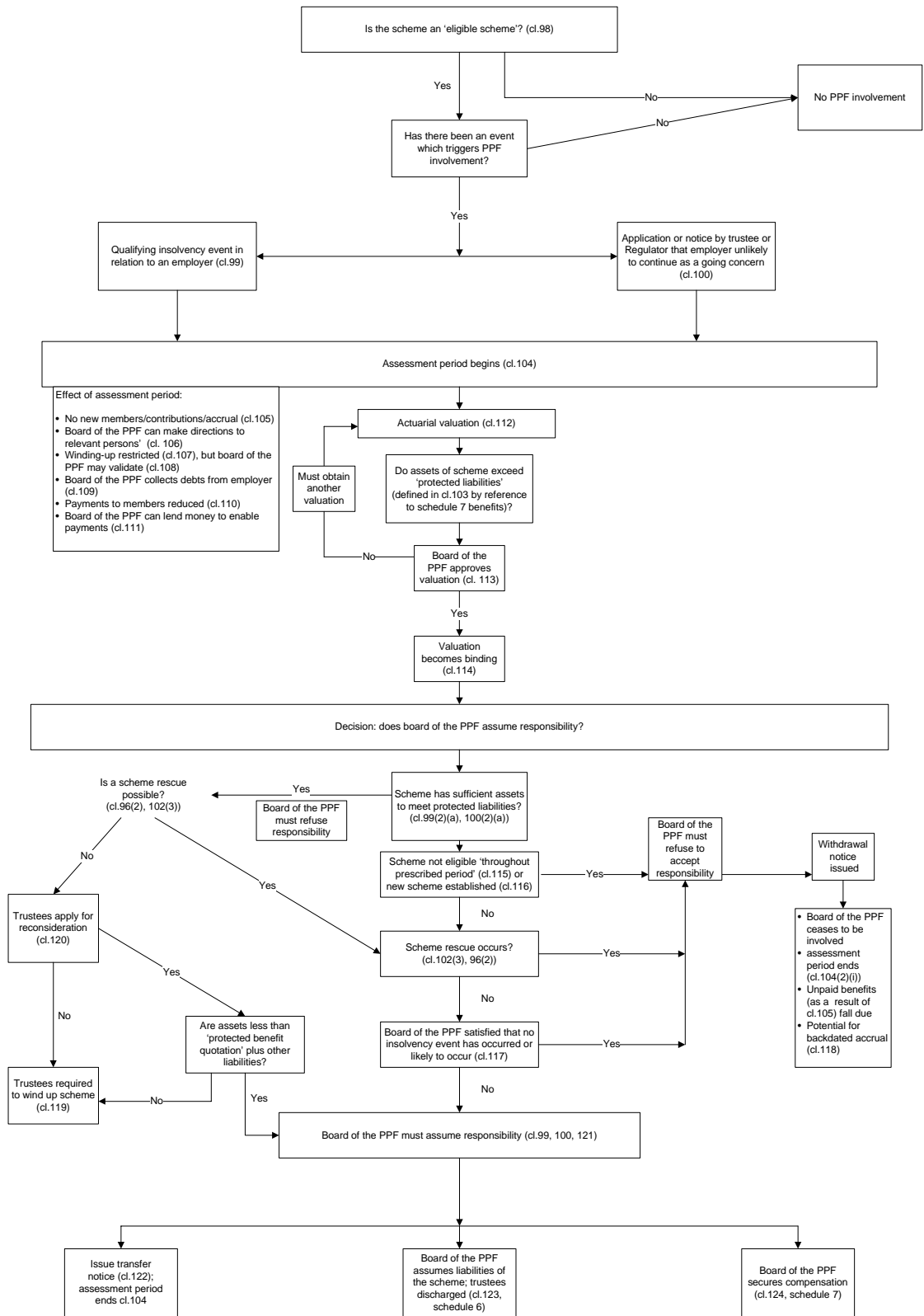
It has also been pointed out that some companies can more easily raise debt to cover shortfalls in their pension schemes (for example Marks & Spencer's recent bond issue) and so avoid the risk-based levy, while those 'dodgy companies' that are not in a position to raise finance in this way will struggle and pay an ever higher levy to the PPF.

There are also issues about the effect of the assessment for the risk-based levy on the willingness of schemes to invest in equities. If the assessment for the risk-based levy takes into account issues like the surplus or otherwise of the pension fund, the company's solvency and the fund's mix of assets and liabilities, a scheme which invests heavily in equities is likely to pay a higher levy than one investing primarily in bonds. However, one of the reasons the government wants to abolish the minimum funding requirement is to allow those funds that wish to invest in equities to do so. This objective will be undermined by the imposition of a higher levy on schemes taking higher investment risks.

#### **Discharge of the PPF's liabilities**

Where the PPF has taken on responsibility for a scheme, the Pensions Bill provides that it may secure the protected liabilities by a number of means. These include insurance, annuity contracts and transferring the benefit of such policies. Regulations will provide for cases where the PPF assumes responsibility for a scheme under which members have accrued rights to money purchase benefits and will detail how such benefits can be secured. The money purchase elements must be considered by the PPF when it considers the appropriate level of compensation.

# Appendix A



## Appendix B

### Schedule 7: compensation payable by PPF

|                            | <b>Pensions in payment at the assessment date</b>  | <b>Pension benefits postponed at assessment date</b>   | <b>Active members over normal pension age at assessment date</b>  | <b>Active members not over normal pension age at assessment date</b>  | <b>Deferred members not over normal pension age at assessment date</b>   |
|----------------------------|--|--|---|---|--|
| <b>Position for member</b> | <p>Entitled to periodic compensation from the assessment date for life at:</p> <ul style="list-style-type: none"> <li>• 100 per cent (of the annual rate under the scheme rules) if has achieved NRA or ill-health retirement; or</li> <li>• 90 per cent otherwise.</li> </ul> | <p>Entitled to periodic compensation at 100 per cent (of annual rate under scheme rules) from assessment date for life where the member:</p> <ul style="list-style-type: none"> <li>• has reached NRA; and</li> <li>• is entitled to present payment, but payment is postponed.</li> </ul> | <p>Entitled to periodic compensation at 100 per cent (of accrued amount) from assessment date for life.</p> <p>Accrued amount is: Accrual rate x pensionable earnings x pensionable service.</p> <p>There are restrictions on what may be taken into account in calculating the accrued amount.</p> | <p>Where member survives to NRA, entitled to 90 per cent of accrued amount from assessment date for life.</p> <p>Accrued amount is: Accrual Rate x pensionable Earnings x pensionable Service.</p> <p>There are restrictions on what may be taken into account in calculating the accrued amount.</p> | <p>Where member survives to NRA, entitled to 90 per cent of protected pension rate (plus revaluation) from assessment date for life.</p> <p>Protected pension rate is accrued amount under admissible rules of scheme.</p> |
| <b>Widow/widower</b>       | Entitled upon death of member (on or after assessment date) to half the annual rate/accrued amount to which the member was entitled.   |  |   |   |  |
| <b>Lump sums</b>           | Not applicable.  | Where entitlement to a scheme lump sum is postponed, member entitled to 100 per cent of accrued amount under scheme rules, as long as NRA reached.   |   | Where entitlement to a lump sum is postponed, member entitled to 90 per cent of accrued amount.   |  |
| <b>Commutation</b>         | Not applicable.  | Can opt to commute for a lump sum up to 25 per cent of periodic compensation.  |   |   |  |
| <b>Early payment</b>       | Not applicable.  |  |   | <ul style="list-style-type: none"> <li>• Regulations to prescribe circumstances when can have payment prior to NRA.</li> <li>• Board of the PPF to determine actuarial reduction applicable.</li> </ul>   |  |
| <b>Dependents</b>          | Regulations to provide.  |  |   |   |  |

|  |  |   |  |
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