# Simplicity, security, and choice: technical paper

December 2002

DWP Department for Work and Pensions

**SIMPLICITY, SECURITY AND CHOICE: TECHNICAL PAPER**

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## SIMPLICITY, SECURITY AND CHOICE: TECHNICAL PAPER

## FOREWORD

This technical paper accompanies the Green Paper "*Simplicity, security and choice: Working and saving for retirement*" [Cm 5677], published on 17 December 2002. It sets out in more detail those aspects of the Green Paper involving technical changes in the field of regulatory reform for occupational and personal pensions. The Government is also publishing a companion paper which sets out the details of proposed changes in the taxation regime for pensions. The findings of the Quinquennial Review of the Occupational Pensions Regulatory Authority (Opra), published on 17 December 2002, are also relevant, and the Green Paper sets out our proposals for the new regulatory framework within which these technical reforms would be implemented.

The details of pensions legislation matter. Where that legislation is over-complex, too prescriptive, inadequate, or produces unintended and unsatisfactory consequences, it does a disservice to pensions in the UK generally. Too often, this results in schemes which are not as good as they should be, poor deals for scheme members, and ultimately a failure to maximise pension saving and planning. That jeopardises our pensions future, as a nation and as individuals.

The options for regulatory reform, set out in the Green Paper and explained in greater detail here, are designed to tackle these problems. In many areas we are seeking to simplify, or to reduce excessive statutory prescription. This should make it easier for employers to provide pensions and to keep their pension promises, and easier for everyone to understand the law on pensions as it stands. We are aware that, in some areas at least, complexity and its resulting confusion really stem from successive layers of different regulatory regimes, including previous attempts at simplification. Where this is the case, we are consulting on whether changes should be made retrospectively as well as for the future. We hope it will be possible to do this with results that are fair and practical; if not, then mindful that today's simplification can easily become tomorrow's added layer of complexity, we need to consider seriously whether change or no change is the better option in particular areas.

In other sections of the paper, we set out options for strengthening member protection. There has been a lot of recent concern about under-funded pension schemes being wound up. In some cases, scheme members, including those nearing the end of their working lives, have lost much of their pension entitlement. This paper sets out the details of the options contained in the Green Paper for addressing the issue. People should be able to have confidence in the pension they have been promised.

The options set out in this document cover most of the regulatory issues on which we are seeking views. However, the Green Paper and the forthcoming Pensions Bill which we intend shall result from it, deal with many other aspects of pensions as well. Therefore, while we would particularly welcome views on the options set out in this document, we will also consider contributions on other issues.
Responses will normally be available to the general public unless you specifically ask us to keep your views confidential.

We look forward to receiving your views in this highly important area.

Rt Hon Ian McCartney MP
Minister for Pensions
December 2002

## SUMMARY OF ISSUES FOR CONSULTATION; AND HOW TO RESPOND

1. The consultation, which will run from 18 December 2002 until 28 March 2003, will aim to take views from academics, the financial services industry, consumer (working age and pensioner) representative organisations, employers' and employees' representative organisations and pensions practitioners.

2. The Government would welcome comments and views from individuals and organisations. If you are responding on behalf of a representative group or organisation, it would be helpful if you could make this clear.

3. Please address any comments on this paper by 28 March 2003 to:

Working and Saving for Retirement Consultation
Department for Work and Pensions
Pensions Strategy Team
3rd Floor
Adelphi
1-11 John Adam Street
London
WC2N 6HT

4. Comments can also be sent by email to: pensionsresponse@dwp.gsi.gov.uk

5. The information you send to us may need to be shared within the Department for Work and Pensions and the Inland Revenue and/or published in a summary of responses received as part of this consultation. We will assume that you are content for us to do this, and that if you are replying by email, your consent overrides any confidentiality disclaimer that is generated by your organisation's IT system, unless you specifically include a request to the contrary in the main text of your response to us.

## CHANGES TO CONTRACTING OUT

6. Requirement to provide survivors' benefits: the Government would not introduce changes in this area unless it had good reason to believe that the coverage of and contributions to occupational pensions would be higher than would otherwise be the case. We would welcome views on whether this would be likely in light of the options covered in this paper.

7. Requirement to provide Limited Price Indexation: the Government would not introduce changes in this area unless it had good reason to believe that the coverage of and contributions to occupational pensions would be higher than would otherwise be the case. We would welcome views on whether this would be likely in light of the options covered in this paper. We would also welcome views on the specific proposal to limit compulsory indexation to pensions up to £30,000 a year.

8. The Reference Scheme Test (RST): we want to provide schemes with a more appropriate benchmark with which to comply and are therefore seeking views on possible reform of the RST. We are seeking views on the option of moving to a

reformed RST, and on how individual measures would work together in a package. We would also welcome views on further variations to the RST, and on whether reform of RST is likely to encourage more contracted-out provision. We are also seeking views on the option of permitting the conversion of accrued benefits on an actuarially equivalent scheme wide basis into benefits under a reformed RST; and on how this conversion could be achieved.

9. Simplification of Guaranteed Minimum Pensions: we want to find workable and affordable ways to relieve administrative burdens on schemes. In particular, we want to simplify future and past regimes. We propose to work with pensions experts on how to carry forward this simplification. At the same time, the pensions framework will offer appropriate protection for members. We would welcome views on the principle and on potential solutions.

10. We would welcome views on how to simplify the anti-franking provisions if they are retained.

11. We are seeking views on proposals for removing the restrictions around the age at which contracted-out rights are payable and the removal of rules that prevent the payment of a lump sum from contracted-out rights.

12. We would welcome views on the option of increasing the trivial commutation level, to say £520 a year, possibly coupled with restrictions, for example based on age, around when a trivial pension can be commuted. This is in line with the Inland Revenue’s tax simplification proposals under which people over 65 whose total matured pension funds from all sources amount to no more than £10,000 would be able to take them, if they wished, as a lump sum.

13. We are considering the abolition of Contracted-Out Mixed Benefit Schemes (COMBS). We would welcome views on this; and, if the facility were to be abolished, on whether existing COMBS should be allowed to continue to contract out on a mixed benefit basis, or whether they should be required to convert their benefits into either defined benefits or defined contribution benefits.

14. We would welcome views on the option of abolishing safeguarded rights arising from pension sharing on divorce, subject to retaining the requirement that the total value of the pension share allocated to a former spouse must be used to provide pension benefits.

15. We are proposing to remove the requirement to obtain member consent when a member's total entitlement consists solely of an Equivalent Pension Benefit, and allow commutation where the member does not object.

## GREATER FLEXIBILITY FOR SCHEMES

16. We would welcome views on simplifying the arrangements under which schemes are restricted from modifying accrued rights with, where possible, examples of the sorts of rule changes that schemes might want to make where our suggested option would assist. To inform discussion, we would also welcome examples of changes schemes might wish to make where the option outlined in this paper would not be of

assistance; and any alternative suggestions that would give schemes more freedom to make changes to their rules without undermining the pension promise.

17. We would welcome comments on options to reduce the level of prescription on selection processes for member-nominated trustees.

18. We welcome views and comments on an option for modifying provisions on internal dispute resolution; and, in particular, on the option of prescribing a time limit within which a scheme must give a decision - would six months be the right length of time?

## PRESERVATION AND TRANSFERS

19. We propose to retain the current requirements to re-value preserved pensions. However, there are some very complex requirements which may no longer be necessary for example, the rules on money purchase uniform accrual. We would welcome views on any other requirements which are considered particularly burdensome.

20. We believe that there is scope for making the legislation relating to transfers simpler by consolidating the legislative requirements and removing obsolete provisions and duplication. This would reduce some of the complexity. We would welcome views about any other specific requirements which may be unnecessary or too detailed.

## COMMUNICATION WITH SCHEME MEMBERS

21. We would welcome views on rationalising the legislation and for replacing many of the current detailed time limits with a “within a reasonable time” approach that the regulator would give guidance on and, where necessary, adjudicate on. In particular we would welcome views on:

- what information items that are currently supplied automatically could instead be made available on request;
- what particular pieces of information should continue to have specific time limits attached to them;
- what other areas of legislative prescription could be removed without having an adverse effect on members and their understanding of their pension arrangements.

## PENSIONS ON DIVORCE

22. We would welcome views on a number of potential simplifications to legislation on pensions on divorce.

## PROTECTION IN THE CASE OF WIND-UP

23. With respect to insolvent employers, we propose to retain a Priority Order within legislation. We would welcome views on the possibilities of:

- increasing the priority given to people who are approaching retirement age;
- basing the level of protection on the number of years the individual has contributed to the scheme, irrespective of age.

24. We would welcome views on options to achieve a fairer sharing of assets between those with larger and smaller pensions, for example through a capping mechanism for early retirees, or for all. We would welcome views on the advantages and disadvantages of the individual options described and on the possible combination of options that could be implemented.

25. We could create a new category of creditor. Pension schemes could be given a higher priority than other unsecured creditors but still have lower priority than preferential and secured creditors. This would reduce the potentially adverse economic effects. However, other unsecured creditors – for instance trade suppliers, consumers and employees – would lose out. They might consider they have at least as much right as a pension scheme to a share of the insolvent employer's assets. As a result, some - such as trade creditors – might have to downsize or go into insolvency themselves. We need to strike a careful balance between the potential impact on business and the need to provide adequate protection for members. We would welcome views on this balance.

26. We are interested in considering the establishment of a central fund into which members could choose to pay the funds that they receive on wind-up. The fund could then – acting as a whole – negotiate the purchase of deferred annuities with providers. Another possibility would be to introduce an insurance scheme, perhaps a Central Discontinuance Fund, providing pensioners and non-pensioners with greater protection against the possible pension implications of insolvency. Different models would offer differing degrees of benefit-replacement and guarantee. The additional protection could be funded by, for example, a reduction in pension benefits or increased contribution rates. The cost would need to be balanced against the greater overall level of security offered. We would welcome views on these options and their potential impact.

27. There are currently restrictions on the amount of compensation that can be paid in cases of dishonesty. For defined benefit schemes, it is restricted to the amount needed to bring the value of the scheme's assets up to 100 per cent of its liabilities for pensioners and members within ten years of retirement, and 90 per cent of its liabilities for other members or, if lower, the amount of the actual loss. For defined contribution schemes, compensation is limited to 90 per cent of the loss.

28. We propose to remove restrictions on the amount of compensation that can be paid in cases of dishonesty, so that schemes with an insolvent employer can be compensated for the full amount lost as a result of acts of dishonesty.

29. With respect to solvent employers, we can see arguments for an against increasing the amount that employers are required to put into the pension fund if they choose to wind up the scheme. The Government will be guided by the aim of not increasing the overall burden on employers providing pensions. We would welcome views on the appropriate balance to strike here.

30. We would welcome any suggestions on how winding up could be further speeded up. We would also welcome views on the Pickering Report's proposal to allow liabilities on wind-up to be discharged to a stakeholder pension or other defined

contribution vehicle provided the member does not object and provided the person was over ten years away from normal retirement age.

## TRANSFER OF UNDERTAKINGS (PROTECTION OF EMPLOYMENT)

31. Were the Government to extend a degree of protection for occupational pension rights to purely private sector transfers, such protection would need to be simple, flexible and worthwhile. Two possible options for extended protection that might fulfil these criteria are set out. We would welcome comments on this general issue and on these suggested proposals. In the context of Option II we would welcome suggestions on the employers' contribution rates (including levels and age-related contributions) when the new employer provides a stakeholder or Group Personal Pension scheme.

## IMMEDIATE VESTING

32. We propose requiring that rights in all schemes should vest immediately with the proviso that *de minimis* amounts can be transferred without consent. We would welcome views.

## TRANSFERS WITHOUT CONSENT

33. We propose that trustees of occupational pension schemes should be able to transfer *de minimis* amounts to a stakeholder pension where members left the schemes more than six months previously, providing the members do not object, were aware of the proposal to do so at the time they ceased to participate in the scheme, and do not ask for the rights to be transferred elsewhere.

34. We would welcome views on whether a *de minimis* amount of, say, £7,000 or alternatively a period of five years service in the scheme should apply.

35. We would particularly welcome comments from stakeholder pension providers and insurance companies on this option. Would there be any benefit in requiring the trustees of each pension scheme to nominate a single stakeholder scheme for all transfers unless the deferred member nominates another, or would that happen anyway? We would also be very grateful for any further comments on the option.

## ALLOWING COMPULSORY SCHEME MEMBERSHIP

36. We are considering options for employers, on a voluntary basis, to be able to make membership of their scheme a condition of employment for all new employees. We propose that employees should be able to opt out of the scheme where, for example, they are already contributing to a stakeholder pension. We would welcome views, for example on how broad the opt-out should be.

## PART 1: SIMPLIFICATION

## A. A NEW FRAMEWORK FOR SCHEME FUNDING

### INTRODUCTION

1. We intend to replace the Minimum Funding Requirement (MFR) with scheme-specific funding requirements - a framework for scheme funding which, together with the other proposals outlined in the Green Paper, we believe strikes the right balance between our objectives of additional flexibility and affordability for employers, and adequate protection for scheme members.

2. The MFR came into force in April 1997, and requires private sector defined benefit occupational pension schemes to hold a minimum level of assets to meet their liabilities, as assessed on the basis of the MFR test. It also sets out time limits (usually referred to as the MFR deficit correction periods) within which any under-funding on the MFR basis must be met.

3. The MFR has not worked as intended, and from the outset has given rise to a number of concerns. It has proved to be inflexible and unable fully to reflect the specific circumstances of individual schemes. The need to satisfy the MFR test has also led some schemes to focus too much attention on the impact of short-term market conditions instead of an appropriate strategy for meeting their specific pension commitments. Following a consultation on the future of the MFR, in March 2001 we announced proposals to replace the MFR with a scheme-specific funding approach.

4. We want schemes to be properly funded without placing unnecessary burdens on business. The proposed framework for scheme funding, together with options for strengthening protection for members when a scheme winds up, strikes an appropriate balance between flexibility and affordability for employers, and protection for scheme members.

### SUMMARY OF PROPOSALS

5. The details of the new arrangements have been developed with the assistance of a Consultation Panel of representatives from the pensions industry, employers, trade unions and consumer organisations[1]. The key elements are:

- a requirement for scheme trustees to agree a Statement of Funding Principles with the sponsoring employer, based on the advice of the scheme actuary. This Statement will be a record of decisions taken about the funding of the scheme, setting out the scheme's strategy for funding its pension commitments, and for correcting any funding deficits. The information in the Statement will complement that in the Statement of Investment Principles;

[11]The Panel includes representatives from the Association of British Insurers, Association of Consulting Actuaries, Association of Pension Lawyers, British Chambers of Commerce, Confederation of British Industry, Faculty and Institute of Actuaries, Investment Managers Association, National Association of Pension Funds, National Consumer Council, Pensions Management Institute, Society of Pension Consultants, and Trades Union Congress.

- trustees will be required to obtain a full actuarial valuation of their scheme at least every three years. It will be for the trustees, with the agreement of the employer, and based on advice from the scheme actuary, to determine the funding method used, including the detailed economic and demographic assumptions appropriate to the specific circumstances of the scheme;

- more effective communication with scheme members. A copy of the Statement of Funding Principles will be made available to members on request. We also propose that trustees should be required to send regularly updated information to scheme members containing key information about the funding position of their scheme (see also Section E on communications with scheme members);

- the scheme actuary's duty of care towards scheme members will be clarified.

**PROPOSALS IN DETAIL**

Scheme-specific funding requirements

6. Under the new regime each scheme will be required to determine its own scheme-specific approach to funding and to set this out in a Statement of Funding Principles. This statement will set out the scheme's strategy for funding its pension commitments, and for correcting any funding deficits. It will be drawn up by the trustees with the agreement of the employer, on the advice of the scheme actuary.

7. The Government wants to encourage employers to continue to sponsor work-based pension schemes. However, it is important for sponsoring employers and scheme trustees to agree on matters fundamental to the proper governance of the scheme, such as the funding principles. We propose that in cases where the trustees and the employer cannot reach agreement, the trustees will be given overriding powers to:

- freeze the scheme, that is, to cease any further accruals; or

- wind up the scheme.

8. These powers are intended to give a better balance to the options available to the trustees and the employer in cases where they disagree.

9. For example, the trustees might use these powers in circumstances where the actuary recommends a higher contribution rate than the employer is prepared to agree to, and a satisfactory compromise cannot be reached. The trustees might decide in such a situation that insufficient funds would be paid into the scheme to maintain its funding position at a satisfactory level, and that members' interests would be better protected by freezing future accruals and/or winding the scheme up. The trustees would be required to inform scheme members should they decide on this course of action.

Actuarial valuations

10. Schemes will be required to carry out an actuarial valuation at least once every three years to assess the funding position. As now, these valuation reports will contain an explanation of the funding method and assumptions used and the implications for future contribution rates.

11. It will be for the trustees, with the agreement of the employer, and based on the advice of the scheme actuary, to decide the funding method used in the valuation, including the detailed economic and demographic assumptions appropriate to the specific circumstances of the scheme.

Schedules of Contributions and elimination of any funding deficits

12. After each actuarial valuation, the trustees will be required to put in place a Schedule of Contributions, prepared in accordance with the Statement of Funding Principles, setting out when and how much the employer and the employees will pay into the scheme. The employer must agree the Schedule of Contributions and commit to paying the contributions set out in it; and the actuary will certify that the contributions are adequate for the scheme to remain on track to meet its Funding Principles.

13. If the actuarial valuation shows that the value of the scheme's assets is less than the value of its accrued liabilities, the scheme actuary will advise on the level of contributions needed to eliminate the deficit, on the basis of the actuarial assumptions adopted for the valuation. The period over which the deficit will be eliminated will be scheme-specific, and will be determined by the trustees, with the agreement of the employer, in accordance with the Statement of Funding Principles, and based on the scheme actuary's advice.

14. It is crucial to the funding of the scheme that payments are made in accordance with the Schedule of Contributions. The trustees will generally be required to report to the new regulator, as they are now to the Occupational Pensions Regulatory Authority (Opra), if the employer is not making payments in accordance with the Schedule. To strengthen this key aspect of member security, we propose to empower the new regulator to fine employers if contributions are not paid in accordance with the Schedule.

15. It is also proposed that in these circumstances the scheme's trustees will be given overriding powers to:

- freeze the scheme, that is, to cease any further accruals; or
- wind up the scheme.

16. This will ensure that schemes do not continue to run on for very long periods of time without the appropriate contributions being paid if there is little likelihood that the employer will be in a position to make good the situation. It will extend the options currently available to trustees, albeit that these will be options of last resort.

Transparency and disclosure

17. One of the key features of the scheme-specific funding regime will be a clear focus on transparency and disclosure. Improved awareness and understanding among scheme members and their representatives about how their pension scheme is funded is intended to act as a check and balance under the new arrangements, enabling them to check that the scheme's funding plan is realistic and appropriate. Increased awareness among scheme members and their representatives is also intended to act as a driver to help ensure that trustees pay full regard to the interests of members in managing the funding of the scheme.

18. The Statement of Funding Principles will be available to members on request. It will set out the over-arching funding principles of the scheme, and will act as a parallel document to the current Statement of Investment Principles (SIP). We propose to prescribe in legislation what information should be included in the Statement of Funding Principles, but it will be for trustees to choose whether or not to combine it with the SIP.

19. In addition to preparing a Statement of Funding Principles, we propose that trustees will be required to send all members a document containing key information about the funding position of their scheme. This might include information such as the funding level at the last full valuation of the scheme, the current level of contributions being paid to the scheme, and what is being done to correct any funding deficits. We think that this information should be regularly updated, perhaps on an annual basis, and sent automatically to all members. The Department for Work and Pensions has commissioned research to inform further development of this proposal.

Clarification of the duty of care on the scheme actuary

20. The scheme actuary will play a key role in advising trustees on funding and related matters. To assist the actuary in carrying out his or her professional duties, current professional guidance on the actuary's duties will be consolidated into a new Guidance Note prepared by the Faculty and Institute of Actuaries. The status of the guidance will be strengthened with statutory backing from the Secretary of State for Work and Pensions. This will clarify the duty of the scheme actuary in a flexible, adaptable and transparent way. Enforcement of the requirements of the Guidance Note will fall to the actuarial profession.

The role of the new regulator

21. The new regulator will carry forward the existing powers used by Opra to sanction trustees for non-compliance with the law[2]. Scheme actuaries and auditors will also be placed under a duty to report to the new regulator if Statements of Funding Principles, funding valuations and Schedules of Contributions have not been obtained within the prescribed periods, or if the employer is not making payments in accordance with the Schedule of Contributions. The new regulator will be able to investigate such reports and will also have the following powers in respect of failures to adhere to Schedules of Contributions:

[2] Further detail of the proposals for a new kind of pensions regulator can be found in the Final Report of the Quinquennial Review of Opra, published on 17 December 2002.

- to fine the employer;
- to bring in an independent trustee (the new regulator would be able to determine whether the costs of the independent trustee would be paid for by the employer or by the scheme);
- to remove trustees;
- to freeze the scheme, that is, to cease any further accruals; or
- to wind up the scheme.

## B. CHANGES TO CONTRACTING OUT

1. Since the State Earnings Related Pension Scheme (SERPS) was introduced in 1978, a contracting-out facility has been available. Broadly, in return for the SERPS foregone, the Government provides a contracted-out rebate and the state scheme no longer has responsibility for future benefits. Originally restricted to defined benefit schemes, contracting out was subsequently extended to defined contribution schemes and personal pensions (including stakeholder pensions). The contracting-out facility continued with the introduction of the State Second Pension (S2P) in April 2002.

2. In the Green Paper, we discuss the current arrangements as they apply to occupational, stakeholder and personal schemes, and consider whether contracting out should continue. However, if it is to continue, there are strong arguments in favour of simplification. A number of commentators have criticised the complexity of the contracting-out rules, and this was reflected in the Pickering Report.

3. In broad terms, any changes would be aimed at making the conditions to be met by contracted-out schemes less exacting and eliminating unnecessary differences between the conditions which apply to contracted-out benefits and those which apply to other benefits provided by tax-approved schemes.

### SURVIVORS' BENEFITS

Existing requirements

4. We are clear in the Green Paper that we would not introduce changes to survivors' benefits requirements unless we had good reason to believe that the coverage of and contributions to occupational pensions would be higher than would otherwise be the case. Provision for widows and widowers is a key feature of the contracting-out arrangements and reflects the provision in the State Additional Pension derived from SERPS/State Second Pension. The way in which the legislation affects different types of schemes is summarised below. Pension schemes that are not contracted out do not have to provide for survivors' benefits, although many do so voluntarily.

*Contracted-Out Salary-Related (COSR) schemes*

5. The contracting-out Reference Scheme Test (RST) applies to COSR schemes. To satisfy the test, schemes must provide survivors' pensions that are at least 50 per cent of the member's pension under the test. It applies only to legal spouses.

*Contracted-Out Money Purchase Schemes (COMPS)*

6. The requirement for COMPS to provide for survivors' benefits does not extend to scheme members who are unmarried at retirement. For those who are married, only that part of their pension fund comprising the contracted-out rights must be used to provide a pension which includes survivors' benefits.

*Appropriate Personal Pension (APP) and Stakeholder Pension (SHP) schemes*

7. The legislative requirements for APP and SHP schemes in relation to survivors' benefits are the same as for COMPS. Policyholders who are married at retirement are required to use the part of their pension fund comprising the contracted-out rights to buy an annuity providing survivors' benefits.

8. The Pickering Report proposes that the requirement for schemes to provide survivors' benefits as a condition of contracting out be removed.

*If the requirement to provide for survivors' benefits were removed:*

9. In defined benefit schemes it would be for employers to decide whether or not to provide survivors' benefits on a voluntary basis. In the case of defined contribution arrangements, it would be left to the individual to decide the extent to which such benefits should be built into the pensions package.

10. Amongst today's pension population over 90 per cent of recipients of survivors' benefits are women. This aspect of the pension system in part reflects the labour market behaviour of previous generations of working age people. Some of these labour market trends are expected to persist. For instance, men are more likely to contribute to private pensions today. Currently 48 per cent of working age men are making private pension provision, compared with 36 per cent of working age women[3].

11. Furthermore, as women have longer life expectancies than men, everything else being equal, they would be in receipt of the majority of survivors' benefits.

12. Fewer than 25 per cent of individuals in receipt of a survivor's benefit are also in receipt of any other private pension, i.e. one they have built up in their own right. Although we might expect this percentage to be higher in the future, it does suggest that survivors' benefits are a significant element of many people's retirement income. The average weekly value of survivors' benefit currently paid to women is £53, making up about a third of their total pension income.

13. The following examples illustrate how important survivors' benefits may be to some women upon the death of their husband. Under the Pickering Report proposal the woman may not receive a survivor's pension.

[3] Source: Family Resource Survey 2000/01

Examples

Case 1: a couple who retire on couple's basic State Pension, the man with £40 a week in the State Earnings Related Pension Scheme (SERPS)/Second State Pension (S2P), and the woman with £20 a week in SERPS/S2P; and the man with £150 a week in an occupational pension. Assuming there was no provision of a survivor's benefit, this would represent a total retirement income 40 per cent lower than would be the case under the current arrangements.

Case 2: a couple who retire, each with full single basic State Pension, each with £40 a week in SERPS/S2P; and each with £150 a week in an occupational pension. Assuming there was no provision of a survivor's benefit, this would represent a total retirement income 20 per cent lower than under the current arrangements.

14. As noted, these examples assume that none of an individual's occupational pension would include provision for a survivor's benefit. Any reform would affect only future accruals and we would not reach that position until an entire working life had elapsed. Until then, any reduction in income would be less.

15. This proposal to remove the requirement to provide survivors' benefits is aimed at simplifying the contracting-out arrangements and reducing costs. The Pickering Report considers that this would produce a "playing field which is much more level" for:

- employers, enabling them to offer defined benefit arrangements without the additional costs of providing benefits for employees' dependants. The Report considers that this proposal may play a part in encouraging employers to provide defined benefit pensions;
- individuals, providing greater flexibility for someone to agree with their employer, or determine for themselves, the nature and extent of provision for their survivors, taking account of their individual circumstances.

16. **The Government would not introduce changes in this area unless it had good reason to believe that the coverage of and contributions to occupational pensions would be higher than would otherwise be the case. We would welcome views on whether this would be likely in light of the options covered in this paper.**

## LIMITED PRICE INDEXATION

Existing requirements

17. We are clear in the Green Paper that we would not introduce changes to compulsory indexation requirements unless we had good reason to believe that the coverage of and contributions to occupational pensions would be higher than would otherwise be the case. The indexation requirement for pensions in payment applies to all tax-approved schemes, that is, they are not restricted to contracted-out schemes. The rules have changed at various times and these are summarised below.

*Contracted-Out Salary-Related (COSR) schemes*

18. For pension rights built up between 6 April 1978 and 5 April 1988, there is no requirement for schemes to increase the Guaranteed Minimum Pension (GMP) in payment on an annual basis. The GMP is the minimum pension that schemes had to provide as one of the conditions for contracting out of the State Earnings Related Pension Scheme (SERPS) before 6 April 1997. Instead, the Additional Pension derived from SERPS built up before 6 April 1988 is increased fully in line with the Retail Price Index (RPI).

19. For pension rights built up between 6 April 1988 and 5 April 1997, schemes must increase the GMP in payment each year by the RPI or three per cent, whichever is the lesser. Where the RPI exceeds three per cent, the excess is met through an increase to the Additional Pension.

20. From 6 April 1997 the link with SERPS was broken. The whole of the pension in payment deriving from rights accrued from that date must be increased each year by the RPI capped at five per cent. This requirement is known as Limited Price Indexation (LPI).

*Contracted-Out Money Purchase Schemes (COMPS)*

21. From 6 April 1988, employers have been able to contract their employees out on a money purchase basis into COMPS.

22. For pension rights built up between 6 April 1988 and 5 April 1997, only that part of the pension in payment deriving from the contracted-out rights (known as protected rights) must be increased each year by the RPI or three per cent, whichever is the lesser. Where the RPI exceeds three per cent, the excess is met through an increase to the Additional Pension.

23. From 6 April 1997 the link with SERPS was broken. The whole of the pension in payment deriving from rights accrued from that date, must be increased by the RPI or five per cent whichever is the lesser. This is the LPI requirement.

*Appropriate Personal Pension (APP) Schemes and Stakeholder Pension (SHP) schemes*

24. Employees have been able to contract out of SERPS with an APP from the beginning of the 1987-88 tax year, and with a SHP from the beginning of the 2001-02 tax year. In both types of scheme, only that part of the pension in payment deriving from the protected rights is subject to indexation. For protected rights built up between 6 April 1987 and 5 April 1997, pensions in payment must be increased each year by the RPI or three per cent, whichever is the lesser. Where the RPI exceeds three per cent the excess is met through an increase to the Additional Pension. From 6 April 1997 the link with SERPS was broken. That part of the pension in payment deriving from protected rights accrued after that date must be increased by the RPI or five per cent, whichever is the lesser.

*Occupational pensions that are not contracted-out*

25. For rights accrued before 6 April 1997, there is no requirement for either defined benefit or defined contribution occupational schemes to increase the pension in payment. That part of the pension in payment deriving from rights accrued on or after that date, must be increased each year by the RPI or five per cent, whichever is the lesser.

*Personal pensions and stakeholder pensions that are not contracted-out*

26. There is no requirement for these schemes to increase the pension in payment.

27. An individual receiving a non-increasing pension of £100 a week in cash value at the point of retirement would have the same cash value pension in all years of retirement. The table below illustrates the effect of LPI on this same weekly pension for various rates of inflation:

| **Inflation rate** | **Years into retirement** | | | | | |
|---|---|---|---|---|---|---|
| | **5** | **10** | **15** | **20** | **25** | **30** |
| 0% | £100 | £100 | £100 | £100 | £100 | £100 |
| 2.5% | £113 | £128 | £145 | £164 | £185 | £210 |
| 5.0% | £128 | £163 | £208 | £265 | £339 | £432 |

28. The Pickering Report proposes that there should be no requirement for schemes to provide LPI as a pre-condition for contracting out, and no such prescription on any form of pension.

29. If the requirement to provide indexation were removed:

- defined benefit schemes wishing to remove LPI from accrued benefits would have to comply with a new "equivalent value test". This would protect the value of accrued rights and would need to comply with section 67 of the Pensions Act 1995, and is discussed separately in Section C. Scheme rules would be amended to reduce or remove LPI for future accrual. Pensions already in payment would not be affected;

- for defined contribution schemes, it would be for the member to decide whether or not the pension/annuity purchased was to be subject to indexation. Pensions already in payment would not be affected;

- for APP schemes (personal pensions used for contracting out) and SHP schemes it would be for the member to decide whether or not the pension was subject to indexation. This choice is already available to those who have rights in addition to protected rights. Income from annuities already in payment would not be affected.

30. Removal of LPI would effectively provide greater choice to members of defined contribution pension schemes and owners of APPs and SHPs. However, for members

of defined benefit schemes there would be potential losses if employers chose to take advantage of the increased flexibility provided by this option.

31. Because men form a majority of members of defined benefit schemes we would expect them to form a majority of those experiencing a reduction in expected pension income if this reform were introduced.

32. However, amongst those experiencing a reduction in expected pension income, we would expect women - on average - to experience a greater reduction. This reflects their longer life expectancy. Comparing a defined benefit pension that is indexed with one where no part is indexed, and taking life expectancy figures today, it is estimated that an average man would lose 17 per cent of his expected total pension income over his retirement while an average woman would lose 25 per cent.

33. The Pickering Report argues that LPI is disproportionately expensive for schemes, and because the level of benefits must be guaranteed, it results in a low risk/low return investment strategy. This strategy, the Report suggested, is currently aggravated by a "shortage" of matching assets such as index-linked gilts. For defined benefit schemes this results in increased costs for the employer. The Report suggests that this is one of the drivers for employers switching to defined contribution schemes, where average employer contributions are lower and the cost of indexation is borne by the member. The proposal is aimed at helping reduce some of these costs for employers running defined benefit schemes and to create a level playing field with defined contribution schemes.

34. In defined contribution schemes the indexation requirements require different parts of the pension "pot" to be treated in different ways. In some cases policyholders have to buy more than one annuity in order to meet the requirements. Removing indexation would reduce some of that complexity and ease the administrative burden on schemes and providers.

35. Although lifting these requirements could result, over time, in pensions suffering a reduction in their purchasing power, the Pickering Report takes the view that a non-indexed pension is better than no pension at all. It also argues that those purchasing annuities would have freedom to purchase the type of annuity they feel best meets their needs.

*Options*

36. A number of alternative options to the Pickering Report's proposal on indexation have been suggested:

- reducing the rate of LPI to three per cent, so the annual indexation required on pensions in payment would be the RPI or three per cent, whichever is the lesser;

- amending LPI so the annual indexation required on pensions in payment would be the RPI minus one per cent, or five per cent, whichever is the lesser, or;

- introducing an Indexation Threshold, where the requirement to provide mandatory indexation would be removed for pensions above the limit of the threshold.

*Indexation Threshold*

37. The option of introducing a threshold, where all pensions above a set figure (say £30,000 total entitlement a year) receive no mandatory indexation, is discussed below.

38. Under this option schemes would have the choice of whether or not to provide indexation for pensions which are greater than the limit of the threshold. If the threshold was set at a sufficiently low level, it could represent a significant saving for schemes as they would not be compelled to provide increases to pensions above this amount. This could also act to encourage sponsoring employers to continue, or begin to offer defined benefit provision. But to produce significant savings the threshold would need to be set at such a low level that it would have an impact on those entitled to relatively small pensions who, in the absence of indexation, are likely to become reliant on income-related benefits later in retirement.

39. Furthermore, this option does not represent a simplification of the existing pensions framework and it would add another layer to the existing indexation requirements. Schemes could opt to continue to provide for increases in order to avoid added complexity, thus negating any significant effect of the measure.

40. The amount at which the threshold was set would also dictate the level of saving. Using the example above (£30,000) it is unlikely that removing mandatory indexation when pensions reach this figure would represent a significant saving for schemes. Lowering the threshold would increase the savings for sponsoring employers. However, savings would take time to materialise because schemes would have to honour any promises to pay indexed pensions already made to scheme members, by either continuing to provide indexation on rights already accrued or replacing those rights with something of equivalent value.

41. The table[4] below shows proportions of recently retired pensioners with annual occupational pensions of various sizes.

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[4] Source: Family Resource Survey 2000/01.

| Size of pension (£ per year) | Number of people[5] | Percentage[6] |
|---|---:|---:|
| 0-4,999.99 | 471,000 | 50 |
| 5,000-9,999.99 | 241,000 | 26 |
| 10,000-14,999.99 | 96,000 | 10 |
| 15,000+[7] | 139,000 | 15 |

42. There is a significant concentration around the £10,000 per year mark. This concentration suggests that the level of any threshold would be such that:

- if it were high (£30,000 per year), very few people would be affected and therefore any savings would be minimal. Based on the table above we estimate that the option would have an impact on under five per cent of the recently retired members in this sample;

- if it were low, savings for sponsoring employers would be significant but the losers would be the moderate earners whose pensions this option is aimed at protecting.

43. **The Government would not introduce changes in this area unless it had good reason to believe that the coverage of and contributions to occupational pensions would be higher than would otherwise be the case. We would welcome views on whether this would be likely in light of the options covered in this paper. We would also welcome views on the specific proposal to limit compulsory indexation to pensions up to £30,000 a year.**

**THE REFERENCE SCHEME TEST (RST)**

44. Prior to 6 April 1997 people who were contracted out on a defined benefit basis accrued rights to Guaranteed Minimum Pensions (GMPs). These were broadly equivalent to the rights they would otherwise have earned in SERPS. From 6 April 1997 GMPs ceased to accrue and the link with the state scheme was broken. From that date the provisions in the Pensions Act 1995 require contracted-out defined benefit schemes to meet an overall scheme quality test - the Reference Scheme Test - instead of having to provide GMPs.

45. In order to meet the RST and contract out, schemes are required to provide benefits that are broadly equivalent to, or better than, those specified in the test. The RST is a benchmark set as a minimum requirement for contracting out status. Individual schemes often provide a level of benefits above the RST minimum.

46. Whilst the RST is fairly straightforward to operate, less stringent arrangements could help to simplify the contracting-out process and reduce the costs involved. **We want to provide schemes with a more appropriate benchmark with which to**

[5] Figures rounded to the nearest thousand.

[6] Figures rounded to the nearest full percentage point. Figures may not sum due to rounding.

[7] Sample sizes too low to show breakdowns at higher income levels.

**comply and are therefore seeking views on possible reform of the Reference Scheme Test.**

47. The table below sets out the current arrangements which a scheme has to meet and a possible option for a reformed RST:

| | **Current test** | **New test** |
|---|---|---|
| **Pension age** | 65 | Scheme rules (but no later than 65) |
| **Pension accrual rate** | 1/80th | 1/100th (one per cent) |
| **Pensionable salary** | Average qualifying earnings in the last three tax years | Career average earnings, cumulatively re-valued by prices up to five per cent a year (or, allow schemes the option of final salary, as in the current test, or re-valued career average earnings) |
| **Qualifying earnings** | 90 per cent of earnings between the Lower Earnings Limit (LEL) and the Upper Earnings Limit (UEL) | All earnings (though some restrictions may be required) |
| **Pensionable service** | The maximum number of years' service should not result in an annual pension greater than half the earnings on which it is calculated | No change |
| **Spouse's pension** | 50 per cent of the member's pension under the RST | This aspect of the test is discussed separately above |

48. Under current arrangements a scheme is deemed to have met the RST if it provides pension benefits which for at least 90 per cent of individual members are broadly equivalent to (or better than) the RST minimum. This allows schemes some flexibility. Under the reformed RST this flexibility could be extended by reducing the 90 per cent to 80 per cent.

49. Under the "new test" option set out above, those administering pension schemes would have a simplified, less stringent benchmark with which to comply in order to achieve contracted-out status. This would allow more flexibility for firms in designing benefit structures.

50. This possible change could offer employers potential cost reductions, but could reduce members' potential benefits for future service, to the extent that scheme rules were aligned with the new test. Where provision was made at the minimum required level, a full future career of pension accrual under the test outlined above could see some individuals receive a pension up to 30 per cent lower than they would without

the reform. A significant factor for those with strong earnings progression would be moving to career average earnings. Consequently, the reduction in income might be suffered disproportionately by higher earners.

51. The 1995 survey by the Government Actuary's Department estimates that of the 4.9 million members of private-sector defined benefit occupational pensions - those potentially affected most by this reform - the majority were men. Within the public sector, the survey estimated that roughly equal numbers of men and women were members of such schemes.

52. The potential reduction in future benefits could be justifiable if the behavioural response from employers were to result in more pension provision than would otherwise be the case.

53. **The Government is seeking views on the option of moving to a reformed RST (an option is outlined in the table above), and on how the individual measures would work together in a package. We would also welcome views on further variations to the RST, and on whether reform of RST is likely to encourage more contracted-out provision.**

54. In order to prevent adding a further tranche to the existing layers of benefit for differing periods of accrual, the Pickering Report proposed that schemes should be able to convert all scheme benefits, both past and present, on the basis of actuarial equivalence to meet the simpler RST set out above.

55. If accepted this option could be extended to active and deferred scheme members, but not to pensioners, and would apply on a scheme-wide rather than individual member basis.

56. There would need to be a cross-reference in the legislation to ensure that these options, if pursued, did not conflict with, or were not prevented by, the provisions of section 67 of the Pensions Act 1995 (see Section C).

57. **We are therefore seeking views on the option of permitting the conversion of accrued benefits on an actuarially equivalent scheme wide basis into benefits under a reformed RST. The Government would also welcome views on how this conversion could be achieved.**

**SIMPLIFICATION OF GUARANTEED MINIMUM PENSIONS (GMPs)**

58. From April 1978, in order to contract out of SERPS, a defined benefit pension scheme had to promise that its benefits would be no lower than the GMP – an amount based on the individual's earnings, which was broadly equivalent to the SERPS foregone. GMPs ceased to accrue on 5 April 1997. However, residual GMP rights still exist for those who were members of a contracted-out defined benefit scheme between the two dates above.

59. It has been argued that keeping residual rights to GMPs creates significant problems for pension scheme administrators. Apart from the costs of running separate systems, securing the GMP causes difficulties and delays when transferring benefits

to another scheme or when schemes are winding up. This, in turn, creates unnecessary uncertainty for scheme members. The different requirements that apply for pension increases (both during deferment and in payment) in respect of GMPs as compared with other benefits also create administrative complexity.

60. A number of ways to reduce these difficulties have been put forward in the past, but none that did not create their own problems. Rather than put forward proposals at this stage, the Government intends to undertake further consultation with the pensions industry and others, with a view to identifying whether the difficulties experienced by pension schemes can be relieved.

61. **The Government wants to find workable and affordable ways to relieve administrative burdens on schemes. In particular, we want to simplify future and past regimes. We propose to work with pensions experts on how to carry forward this simplification. At the same time, the pensions framework will offer appropriate protection for members. We would welcome views on the principle and on potential solutions.**

Anti-franking

62. The anti-franking legislation was passed in 1984. Its intention is to protect benefits over and above the GMP from being eroded, by preventing them from being used to provide for the required increases to GMPs. The anti-franking rules set out the minimum amount of pension that must be payable to members when their GMP comes into payment.

63. Further legislation was included in the Child Support, Pensions and Social Security Act 2000. These measures are currently on hold pending the outcome of this review of the regulatory framework.

64. It is widely acknowledged that the existing anti-franking provisions are exceptionally complex, and many schemes may not be fully compliant.

65. It is the Government's view that if we can find a workable solution to the problems associated with GMPs the problem of franking could be much reduced or disappear. In either case we would need to consider whether anti-franking legislation was necessary. We therefore propose to continue to delay, indefinitely, the introduction of the anti-franking provisions contained in the Child Support, Pensions and Social Security Act 2000.

66. **We would welcome views on how to simplify the anti-franking provisions if they are retained.**

## RESTRICTIONS ON HOW AND WHEN BENEFITS CAN BE TAKEN

67. Currently there are a number of restrictions around when and how contracted-out benefits can be paid. These restrictions do not apply to non contracted-out rights. This adds to the administrative burden and complexity faced by those overseeing contracted-out pension schemes.

68. Existing legislation provides for contracted-out rights in occupational defined contribution and personal pension schemes to be paid from a certain age. Further, no part of the contracted-out rights may be taken as a lump sum except in certain circumstances on grounds of triviality or (excluding GMP and protected rights) serious ill health.

69. The Pickering Report proposed that pension schemes and pension scheme members should have greater flexibility around when and how contracted-out rights are taken, thus easing the administrative burden they face when handling contracted-out rights. Specifically it suggested**:**

- revising the rules restricting the age from which contracted-out rights are payable, leaving only those rules which apply to tax-approved schemes; and

- removing the rules that prevent lump sum payments being paid from contracted-out rights, leaving only those which apply to tax approved schemes, possibly with the proviso that the pension payable after a lump sum has been taken must be at least equivalent to an accrual rate of one per cent.

70. Pursuing these options may encourage contracting out as it is likely that they would be attractive to both schemes and individual members. But they are not without disadvantages. A combination of taking the maximum lump sum and giving effect to the pension at an earlier age could have a considerable impact on the headline pension payable. These options also run counter to the principle that contracted-out rights should replace lost State scheme benefits.

71. **We are therefore seeking views on the proposals for removing the restrictions around the age at which contracted-out rights are payable and the removal of rules that prevent the payment of a lump sum from contracted-out rights.**

Trivial commutation

72. Commutation of trivial pensions is permitted to save schemes and pension providers the expense of recurring small payments. Under the contracting-out legislation, if the aggregate of total benefits payable to the scheme member does not exceed £260 a year the pensions, including any arising from the payment of voluntary contributions, may be commuted.

73. The commutation limit of £260 a year – broadly equivalent to a fund of £5,000 - has been in place for a number of years. Having to administer small amounts, which are only marginally above the commutation limit, adds disproportionately to schemes' administrative burden and concerns have been raised with us about the potential annuity rates available for small amounts.

74. **We would welcome views on our option of increasing the trivial commutation level, to say £520 a year, possibly coupled with restrictions, for example based on age, around when a trivial pension can be commuted. This is in line with the Inland Revenue's tax simplification proposals under which people over 65 whose total matured pension funds from all sources amount to no more than £10,000 would be able to take them, if they wished, as a lump sum.**

## OTHER CONTRACTING-OUT PROPOSALS

Contracted-Out Mixed Benefit Schemes (COMBS)

75. COMBS were introduced as part of the 1997 reforms. Only a small number of schemes currently take advantage of this facility and we believe the ability to contract out on a mixed benefit basis adds unnecessary complexity to the contracting-out legislation. **We are therefore considering the abolition of this facility**.

76. **We would welcome views on this; and, if the facility were to be abolished, on whether existing COMBS should be allowed to continue to contract out on a mixed benefit basis, or whether they should be required to convert their benefits into either defined benefits or defined contribution benefits.**

Safeguarded rights arising from pension sharing on divorce

77. The Welfare Reform and Pensions Act 1999 introduced measures to give the courts power to share the value of pension rights between couples at the point of divorce. Pension sharing allows the value of pension rights to be shared as part of the divorce settlement. The value of other financial assets could already be shared and this continues to be the case. The value of pension rights included in the financial settlement is divided according to the court order, with the proviso that the value shared is used to provide pension benefits for the former spouse to whom it is allocated.

78. Where a pension share contains a value derived from contracted-out rights the former spouse is entitled to safeguarded rights, the value of which must provide benefits broadly equivalent to contracted-out rights. These safeguarded rights are ring-fenced and are subject to slightly modified conditions that apply to post-1997 salary-related contracted-out rights.

79. The Pickering Report proposed removing the restrictions on the share of the pension derived from contracted-out rights. Although safeguarded rights were introduced to provide protection for the contracted-out element of the pension share, it can be argued that the court order and family law provide adequate protection. The Government has considered this option and thinks that the abolition of safeguarded rights would provide pension schemes with an administrative easement. Whilst this is not great, due to relatively few pension sharing orders on divorce, it would provide schemes with a technical easement.

80. **We would therefore welcome views on the option of abolishing safeguarded rights, subject to retaining the requirement that the total value of the pension share allocated to a former spouse must be used to provide pension benefits.**

Equivalent Pension Benefits (EPBs)

81. EPBs are the benefits that were provided for an employee who was contracted-out of the graduated pension scheme - the predecessor of SERPS. EPBs ceased to accrue in 1975. From 6 April 2002, where a member's rights under a scheme consist solely of

EPBs, these rights can, under prescribed circumstances, be fully commuted and taken in lump sum form prior to normal pension age, with member consent.

82. The requirement to obtain the member's consent is the remaining fetter around the handling of EPBs. **We are therefore proposing to remove the requirement to obtain member consent when a member's total entitlement consists solely of an EPB, and allow commutation where the member does not object.**

## C. GREATER FLEXIBILITY FOR SCHEMES

## SIMPLIFYING THE ARRANGEMENTS UNDER WHICH SCHEMES ARE RESTRICTED FROM MODIFYING ACCRUED RIGHTS

Existing provisions

1. Section 67 of the Pensions Act 1995 prevents changes being made to the rules of a scheme that would reduce a member's accrued pension rights without the member's consent. It preserves not just the value of the member's rights, but the rights themselves. It has been argued, notably in the Pickering Report, that section 67 is one of the factors that influences decisions on future pension provision. Because a defined benefit scheme which is faced with unsustainable costs cannot modify the existing pension rights of members, it is increasingly left only with the drastic option of closing the scheme or switching to a defined contribution arrangement. The Report argues that as section 67 is currently constructed, many wholly proper amendments, which are justifiable in terms of members' interests and are essential to enable a scheme to adapt to changing circumstances, cannot be made.

2. Section 67 prevents a change to the rules of a scheme unless the scheme actuary has certified that the change would not be detrimental to members' accrued rights, or the members consent to the change. The Pickering Report recommends that those requirements are replaced by an 'equivalent value' test. This would enable schemes to change members' pension rights for past service without their consent, so long as the overall value of the replacement benefits provided in exchange are expected (but not guaranteed) to be equivalent in value. The overall value, in actuarial terms, would be maintained, but the benefits themselves would be different. For example, a scheme would be able to extend payment of survivors' benefits from spouses only to all partners - at no extra cost, by, say, reducing the pension accrual rate.

Options for change

3. Whilst acknowledging the arguments put forward in the Pickering Report, we believe that the proposal goes too far because it would permit employers to change fundamentally the terms of the pension scheme in respect of a member's past service. It could, for example, allow employers to replace all of a member's accrued defined benefit rights with defined contribution rights, without consent. We do not believe that permitting schemes to make such extensive changes would provide the stability and confidence that is so important, and which members of pension schemes are entitled to expect.

4. It is clearly important that employers continue to honour their pension promise in relation to the rights that members have already accrued. We do accept, however, that there is a case for easing the very restrictive nature of section 67, so that schemes can make some changes to their rules which would help them to adapt to changing circumstances (subject to any requirement to consult with employees or their representatives). In this way, we would achieve a better balance between protecting scheme members' accrued rights on the one hand, and enabling schemes to make limited but worthwhile changes on the other.

5. We believe this could be achieved by:

- clarifying the wording of the current legislation; and

- allowing schemes to make changes providing the actuarial value of the change[8] does not exceed a certain percentage limit of a member's total accrued rights - say five per cent (the *de minimis* approach); and

- requiring that where the modification results in a reduction in the value of a member's accrued rights, the rights foregone must be replaced by something of actuarially equivalent value.

6. We believe this approach would address the operating difficulties that schemes are experiencing with section 67 and, at the same time, allow them to do a limited amount of scheme restructuring. It would prevent extensive changes and the effect on scheme members would, therefore, be limited. Any rights that are removed within the *de minimis* provision would always have to be replaced by something else of actuarially equivalent value.

7. An example of how such a rule might operate is where a scheme with two different benefits structures following a company acquisition wanted to make changes in order to consolidate these two structures. It would be able to do so if the actuarial value of the rights being changed did not amount to more than five per cent of an individual's total accrued rights. The rights being changed would have to be replaced by something else of actuarially equivalent value, but the *de minimis* rule would put a limit on the scale of the changes being made. In this way, schemes would have the freedom to make limited restructurings, including making changes to accrued rights, but would be prevented from making wholesale changes without the member's consent.

8. A scheme would not be able to convert a member's accrued defined benefit rights to defined contribution, without the member's consent, because that would mean converting 100 per cent of the person's rights.

9. It would, however, be able to make less significant changes. For example, where, perhaps as a result of a take-over, a company is operating a scheme with two different benefits structures, one paying dependants' benefits on the death of the member in respect of children under age 16, and the other paying in relation to children under age 18, the scheme would be able to modify its rules so that the under age 16 rule applied to all. The actuarial value of the survivors' rights foregone by those members who were previously in the scheme with the 'under 18 rule', would be less than five per cent of their total rights, and the scheme could therefore make the change without member consent. However it would have to replace the rights foregone by those members with something else of actuarially equivalent value. In this case it might give the 'under 18 rule' members some added years (or, because, in this example the value of the rights foregone would be very small, part of an added year).

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[8] In this context "the actuarial value of the change" means: (a) where a particular right is being changed, <u>the difference between the value of the member's total accrued rights before and after the change;</u> and (b) where a right is being replaced completely, <u>the value of that right</u>.

10. **We would welcome views on this option with, where possible, examples of the sorts of rule changes that schemes might want to make where this approach would assist. To inform discussion, we would also welcome examples of changes schemes might wish to make where the option outlined above would not be of assistance; and any alternative suggestions that would give schemes more freedom to make changes to their rules without undermining the pension promise.**

## MEMBER-NOMINATED TRUSTEES – LESS PRESCRIPTION ON SELECTION PROCESSES

11. The Government wants to see more member involvement in the running of occupational pension schemes. We want to see member-nominated trustees (MNTs) in every scheme (see Part 2, Section I).

12. We also accept the findings of the Pickering Report that this is an area where there is scope for significant simplification.

13. We are consulting on the possibility of:

- introducing legislation that provides for all schemes to have a minimum of one third of the trustees (or directors of a corporate trustee) nominated and selected by scheme members; and

- backing this up with guidance issued by the pensions regulator on good practice for nomination and selection arrangements[9].

14. We are seeking views on two options:

- the option put forward in the Pickering Report that provides for only a minimum requirement in legislation – schemes must have at least one third MNTs; and

- an option that qualifies this minimum requirement with a further condition in the legislation that arrangements for nominating and selecting MNTs must be "fair and open".

Option 1 – minimal legislation

*Legislation*

15. Under this option, there would be minimal legislation that would provide for the outcome (one third MNTs) but it would not prescribe how schemes must arrive at that outcome. Responsibility for devising and implementing the nomination and selection arrangements would rest with the trustees of the scheme who, if they failed to implement the requirement, would be subject to sanction by the regulator.

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[9] Further detail of the proposals for a new kind of pensions regulator can be found in the Final Report of the Quinquennial Review of Opra, published on 17 December 2002.

16. There would also be a small number of additional provisions, as in the Pensions Act 1995, to deal with things like:

- exemptions from the requirement to have MNTs (we anticipate similar exemptions to those contained in the existing member-nominated trustee regulations);

- ensuring that arrangements adopted under the legislation override scheme rules where there is a conflict between the two;

- restrictions on trustees so that they cannot unilaterally impose more than the minimum one third;

- protection to ensure that MNTs cannot be removed except with the agreement of all the other trustees;

- protection to ensure that MNTs cannot be excluded from certain trustee functions.

17. We also have to recognise that there will be schemes where there are no members willing to stand as a trustee. We cannot put trustees in a position where they are in breach of a legal requirement through no fault of their own, so the legislation would need to cater for this.

*Guidance*

18. Under Option 1, the regulator would issue good practice guidance on the nomination and selection procedures that it would expect schemes to follow.

19. Guidance would give trustees the flexibility to adopt arrangements that are right for the circumstances of their particular scheme and would be written in plainer language than regulations.

20. The regulator would have power to enforce the legislation but the test would be whether the scheme has at least one third MNTs, not whether the scheme had complied with the guidance. The regulator would encourage schemes to follow its guidance, but the guidance itself would not be enforceable.

21. The guidance would offer good practice suggestions on such things as:

- the meaning of "nominated": this would cover what is seen as good practice in terms of a nomination and selection procedure. "Nominated" would include references to who is eligible to stand for nomination and whether any support for the nomination is required;

- the issues that schemes would need to consider when devising their nomination and selection procedures, such as:
  - whether all members are free to stand for nomination, and whether all members are able to make or support nominations (in particular, the position of deferred and pensioner members);

- geographical or other splitting of the membership;
- minimum or maximum age limits, or minimum length of service criteria;
- whether non-members are eligible for nomination.

- what is considered good practice in terms of the method used to select trustees from the nominations. This would include such things as:
  - treating the candidates as elected unopposed if there are no more nominations than vacancies;
  - any requirements for secret balloting and scrutiny;
  - voting arrangements (first past the post, single transferable vote etc);
  - geographical or other splitting of the membership;
  - the use of selection panels or consultative committees in the selection process, including any restrictions on the constitutions of the panel or committee, for example, that the majority of the members of the panel must not be individuals who represent the employer.

- the meaning of "member": the guidance would set out the factors that trustees need to consider when deciding who is a member for the purpose of nominating and selecting trustees. For example, this could deal with the practicalities of members leaving and joining in the middle of a balloting process;

- dealing with vacancies unfilled because of insufficient nominations: the guidance would cover the issues that trustees would need to consider where there are unfilled vacancies, for example whether a vacancy would be left open, whether a further attempt would be made, or whether (say) the employer would be able to fill the vacancy;

- filling unplanned vacancies: examples of good practice for filling casual vacancies, for example appointing the unsuccessful nominee with the most votes at the previous election;

- the term of office for MNTs: the guidance might recommend a norm, perhaps three to six years as it is now, but then suggest that the trustees use their discretion to vary it if the situation demands it, for example, where a scheme is winding up;

- the circumstances in which MNTs may be removed: this could cover things like whether an MNT would have to stand down if they leave the company;

- nominating and selecting MNTs in multi-employer and industry-wide schemes: this would cover any special considerations for industry-wide and multi-employer schemes;

- selecting member-nominated directors where a corporate trustee is trustee for more than one scheme: this could cover the discretion for trustees to decide whether to aggregate the membership for the purpose of satisfying the requirements;

- revising nomination and selection arrangements: this would cover situations such as:

– where schemes merge or split;
– employers leaving or joining a multi-employer scheme;
– company mergers or restructuring (particularly where the MNT structure is based on a geographical or organisational structure).

*Enforcement*

22. With legislation that is deliberately lacking in prescriptive detail, any test of whether the legislation has been complied with would be measured against the high-level legislative requirement, i.e. whether a scheme had the minimum one third MNTs.

23. The regulator would be able to encourage schemes to follow its good practice guidance but there would be no scope for the regulator to force them to change the arrangements as long as the scheme could show that there was a minimum of one third MNTs.

24. This could create some difficult situations, where, for example, a member or group of members feels the arrangements are unfair, but that is the trade-off that would have to be made if we are to achieve real simplification.

*No prescribed time limits*

25. Much of the prescription in the current legislation is to ensure that MNTs or alternative arrangements are put in place within reasonable time limits. Under the possible alternative arrangements there would be no prescribed time limits. But the regulator could give guidance on time limits and, if a scheme was dragging its feet, it could reach a judgement that the basic one third MNT requirement had not been met and impose a sanction on the trustees.

*Independent trustees*

26. Some schemes have opted for trustees who are independent of both employer and employees, often a professional trustee company. Under the possible alternatives some of the trustees could continue to be independent but there would also have to be at least one third MNTs.

Option 2 – "fair and open"

27. The second option is a variation of the first. In addition to the basic requirement for every scheme to have at least one third MNTs, there would be a condition in the legislation that the arrangements for nominating and selecting the MNTs must be "fair and open".

28. This would put an additional constraint on the trustees when devising their nomination and selection procedures. And, in the event of a dispute or complaint, the regulator would have the power to determine not just whether the scheme had one third MNTs but also whether the nomination and selection procedures had been fair and open. Where a scheme failed either of these tests the regulator would have the

power to order trustees to change their arrangements and, where appropriate, impose a sanction on them.

29. The regulator would produce guidance on what it considered to be “fair and open” but, in the event of a dispute, would test each case on its merits. Schemes that had followed the guidance could be confident that their arrangements would pass the regulator’s “fair and open” test.

30. This option attempts to address what some people might see as an inherent unfairness about Option 1. However, it could have significant resource implications for the regulator. The expression “fair and open” would be open to interpretation, and this could prompt difficult and contentious complaints to the regulator. Schemes might also be tempted to approach the regulator for an opinion on their proposed arrangements before attempting to implement them.

Issues across both options

31. These possible new arrangements would attempt to simplify what many pension practitioners cite as some of the most complex of all pension legislation for what is, essentially, a straightforward objective – to allow scheme members to nominate some of their scheme’s trustees. The reason the legislation is so complex is because, in attempting to achieve fairness, it prescribes how schemes should conduct their nomination and selection arrangements.

32. Both of the options in this paper remove this legislative complexity by giving schemes the flexibility to develop their own nomination and selection procedures. They both rely on guidance produced by the regulator to encourage schemes to follow good practice and both would deliver the desired outcome of at least one third MNTs.

33. Option 1 focuses solely on the outcome, whereas Option 2 also attempts to address the fairness of the nomination and selection procedures by requiring nomination and selection to be fair and open and giving the regulator the power to arbitrate on this in the event of a dispute.

34. The choice we have to make is between the *status quo*; a very straightforward provision that would achieve the desired outcome but perhaps not always in a way that would suit everyone; and one that addresses the fairness issue but is more exacting and would involve the regulator in some costly and very difficult determinations (schemes would have to be in a position to satisfy the regulator that their arrangements are fair and open).

35, **We would welcome comments on the options discussed.**

## INTERNAL DISPUTE RESOLUTION

Existing requirements

36. Since April 1997 occupational pension schemes have been required to have a procedure in place to deal with disputes between the trustees and managers of the scheme and actual and potential scheme members or beneficiaries.

37. The procedure is two-stage and must include provision for the original decision to be reconsidered by the trustees or managers if the complainant is unhappy with the decision reached in the first stage. Regulations set out details of how the process should work including details of how the complaint should be raised and time limits within which responses must be given. Trustees or managers can be fined by Opra if the arrangements are not set up or followed.

38. It is important that schemes have a procedure in place for resolving complaints by members, prospective members and beneficiaries and it is also beneficial to those operating pension schemes. The dispute resolution process operates as a filter to ensure that easily resolved complaints and simple misunderstandings are not referred to the Pensions Ombudsman.

39. Pension scheme rules are often complicated and misunderstandings are inevitable. It is important to have in place a process which allows the scheme administrator/trustee to explain a decision made or action taken or alternatively to remedy problems or inaccuracies before the complaint is escalated out of their hands. This is in the interests of fairness, and to ensure that members are fully informed of the reasons for decisions which affect them. A number of bigger schemes already had a dispute resolution arrangement in place when the legislation was introduced.

Options for change

40. While the concept of some form of complaints procedure has not been questioned, views have been expressed that the process required by legislation is too restrictive, complicated and does not allow schemes to adapt the process so that it is more manageable for the particular scheme concerned. We agree that the process required by legislation is too complicated and needs to be simplified. Members need access to an effective mechanism when disputes arise but the current mechanism does not work to best advantage.

41. We are considering replacing the current requirements with one of the approaches suggested in the Pickering Report as follows:

- all schemes must have a published formal dispute procedure but can choose whether it is in one or two stages;
- complainants must have access to the trustees or managers as part of that process;
- there is a prescribed time limit for the decision in the case to be reached (say six months) and if the scheme fails to give a decision the member can take his complaint to the Pensions Ombudsman; and
- the complainant must be told that Pensions Advisory Service (OPAS) can help when the complaint is received and about the role of the Pensions Ombudsman if the scheme cannot settle the dispute.

42. This framework would be a significant simplification of the existing legislative requirements and would allow schemes to adapt the procedure if they wish. Retaining

a time limit removes any element of uncertainty as to what is a reasonable length of time before a complaint can be escalated. **We welcome views and comments on this option. Would six months be the right length of time?**

## D. PRESERVATION AND TRANSFERS

### PRESERVATION

1. In the past, pension scheme rules could provide that a pension was only payable to those in pensionable service at retirement. Consequently, someone could have been a member of the scheme for twenty years or more but would have no pension rights if they changed jobs before pension age. From April 1975 legislation provided that members of five years' standing had their rights vested in the scheme and the scheme had to preserve those rights until pension age. The five year period was later reduced to two years. Section J of this paper discusses removing the two-year period so that rights in all schemes vest immediately.

2. For members leaving an occupational pension scheme on or after 1 January 1986, post-1984 preserved defined benefits (other than Guaranteed Minimum Pensions (GMPs)) had to be re-valued in line with the Retail Price Index (up to five per cent) for each year between leaving pensionable service and reaching pension age. For members leaving an occupational pension scheme on or after 1 January 1991, re-valuation in deferment by this formula was extended to all non-GMP defined benefits (not just those accrued after 1984). The statutory right to a transfer value was also introduced in 1986. The preservation and transfer rules were intended to reduce disincentives to job mobility. The transfer rules enable someone with several small amounts of pension to transfer them to a single fund.

3. Someone who has rights in an occupational pension scheme should expect them to retain their value to a reasonable extent. **We therefore propose to retain the current requirements to re-value preserved pensions.**

4. **However, there are some very complex requirements which may no longer be necessary for example, the rules on money purchase uniform accrual. We would welcome views on any other requirements which are considered particularly burdensome.**

### TRANSFERS

5. A transfer value from a defined benefit scheme should represent the value of the benefits arising from the member's accrued rights. From April 1997 the minimum amount of a cash equivalent transfer value (CETV) is the value of the member's rights calculated using the same valuation method as that used under the minimum funding requirement (MFR). The actual transfer value can be higher, but may also be reduced to reflect the MFR funding level revealed at the scheme's most recent MFR valuation. This effectively sets a statutory requirement for the calculation of minimum amounts of transfer values. We propose that the requirements relating to transfers values should be less prescriptive by changing the way in which CETVs are calculated. In line with the introduction of scheme-specific funding arrangements (see Section A) trustees should decide the way in which CETVs should be calculated on the advice of the scheme actuary without reference to a statutory underpin. **We propose that legislation should require that CETVs be calculated on a basis that is fair to all, and that the benefits granted in respect of transfer values received into the scheme should continue to be calculated in a consistent way.**

Legislation

6. The legislation on transfers is cited as the cause of administrative difficulties in the operation of occupational pension schemes. It is generally held that the underlying principles are sound, but the degree of detail and sheer volume of regulation is disproportionate particularly in relation to transfers of contracted-out rights. Simplification of the requirements relating to contracted-out rights set out in Section B of this paper, if adopted, would result in simplification of many of the rules on transfers. But we want to simplify the current transfer arrangements irrespective of contracting out. **We believe that there is scope for making the legislation relating to transfers simpler by consolidating the legislative requirements and removing obsolete provisions and duplication. This would reduce some of the complexity. We would welcome views about any other specific requirements which may be unnecessary or too detailed.**

## E. COMMUNICATION WITH SCHEME MEMBERS

1. Current legislation on the disclosure of information to scheme members has built up over a number of years and is spread across a number of different sets of regulations. The legislation prescribes the information that must be made available to scheme members, prospective members and others, and whether it must be sent automatically or made available on request, and within what time limits. Failure to comply with the requirements can attract a sanction from the Occupational Pensions Regulatory Authority (Opra).

2. The Pickering Report highlighted a concern that too much emphasis has been placed on the provision of information and that, whilst this is an important issue, it is not a panacea. The Report acknowledges that communication has a role to play in alerting members to risks and enabling them to take action to protect their interests, but asserts that the provision of information has much more to do with consumer enlightenment than with benefit security.

3. The Report concludes that the provision of too much, poorly targeted information, has resulted either in information being ignored or in people failing to take action which it was in their interests to take. It recommends that any communications should be based on a set of principles:

- communication should be aimed primarily at influencing behaviour. The information should give individuals the facts they need to decide whether to join, stay in or leave a scheme;
- communication should provide members with basic information about their likely pension - including setting out (in broad terms) the risks (for example in a defined contribution scheme, a reminder that the final pension will depend on investment performance and annuity rates);
- individuals should be properly informed of major events which might affect members (for example, relevant changes to scheme design or large numbers of members taking early retirement) and their options on leaving or retiring or what will happen to their pension if they die;
- it is also necessary to provide information to protect members - for example people in defined benefit schemes should have access to information about the funding position; and
- all communication with members should be tested to see whether it is understandable and will work.

4. It recommends that only key pieces of information should be sent automatically to members, with all additional information being available on request.

5. The Report further proposes that the legislation should be less prescriptive in the detail to which it goes, and it should avoid specifying timescales within which particular pieces of information should be communicated. Instead the legislation

should refer to “reasonable timescales” - with the regulator providing guidance on what is “reasonable” and adjudicating in cases of dispute.

## OPTIONS FOR CHANGE

6. We agree that there is a case for rationalising the legislation and for replacing many of the current detailed time limits with a “within a reasonable time” approach that the regulator would give guidance on and, where necessary, adjudicate on. Members must continue to be able to receive all the information and scheme documentation that they are currently able to see, but we will look carefully at each information item to see whether it should be sent automatically or just be available on request. We will also consider whether there is scope for removing any of the prescriptive detail of the regulations.

7. **We would welcome views on this approach, in particular on:**

- **what information items that are currently supplied automatically could instead be made available on request;**

- **what particular pieces of information should continue to have specific time limits attached to them;**

- **what other areas of legislative prescription could be removed without having an adverse effect on members and their understanding of their pension arrangements.**

## MONEY PURCHASE ILLUSTRATIONS

8. The Pickering Report made a specific recommendation about Money Purchase Illustrations (MPIs). It recommended that the only requirements for these illustrations should be that they are provided, with the regulator providing guidance on what information should generally be included with the illustration.

9. **We do not propose to accept this**. It is important that MPIs are consistent between providers and to achieve this we believe that a certain amount of prescription is necessary. We are working with the Financial Services Authority (FSA) and the Faculty & Institute of Actuaries to achieve consistency between MPIs and FSA point of sale projections, in time for the April 2003 start date. And, with the pension industry gearing itself up for these new procedures, we do not believe that this is the time for further changes.

## F. PENSIONS ON DIVORCE

1. The treatment of pensions on divorce (or annulment of marriage) is mainly a family law matter. The procedures to deal with pensions are necessarily set within the overall divorce financial settlement procedures that deal with the general division of assets between a couple divorcing or on annulment of marriage. Family law matters are devolved to Scotland and Northern Ireland. Pension matters are devolved to Northern Ireland. There are some differences in each of the jurisdictions.

2. The process for determining the financial settlement on divorce is known as "ancillary relief". Courts generally have three options for dealing with pensions: offsetting the value of the pension against the value of other assets; earmarking pension lump sums or (except in Scotland) periodical payments for 'maintenance'; or sharing the value. Pension sharing was introduced to give greater flexibility for the courts in determining the financial settlement following divorce so that a fairer financial settlement and a clean break can be more easily achieved. The pension sharing provisions came into force for new divorce/nullity proceedings initiated on or after 1 December 2000. Pension sharing is not suitable in every case. Evidence indicates that Courts and couples still favour the 'offset' option; Court Services data for England and Wales, for example, show fewer than 1,000 sharing orders to date.

### Standardisation and certainty for schemes

3. The legislation dealing with pensions on divorce follows existing pensions legislation. For private pension schemes the legislation standardises the method of valuation, streamlines the information that schemes are obliged to provide for divorce purposes and allows them to recoup the costs of dealing with requests for information and valuations. Considerable costs for pension schemes were involved in preparation for pension sharing; these set-up costs cannot be recovered. This standardisation aims to reduce costs and achieve consistency of treatment in ancillary relief cases. Scheme administration infrastructure is now in place but this, as well as the legislation, will need to be reviewed in the light of the outcomes of the Green Paper consultation on simplification because the pensions on divorce procedures are built into the 'normal' pension provisions and administration structures.

### Derivation of entitlement to benefit from a pension share

4. Scheme members normally accrue pension rights in an occupational scheme by reference to the value of the funds built up from contributions and investments returns, length of pensionable service and in defined benefit schemes by reference to their final or average salary. There is an employment link with the employer contributing and, in contributory schemes, the employee also contributing. Where scheme members satisfy certain conditions, they would be entitled to a package of benefits when they retire from the employment to which the scheme relates.

5. Scheme members whose pension rights are derived from a pension share (called a 'pension credit'[10]) acquire those rights through the value of the spouse's pension

[10] This is different from the Pension Credit to be introduced in October 2003 in replacement of the Minimum Income Guarantee, to reward saving.

rights/benefits allocated to him/her under the divorce/nullity financial settlement Court order. For these ‘pension credit’ members, there is no concept of pensionable service and no rights are accrued by reference to an employment or by payment of contributions in relation to the pension rights acquired. Since there is no employment link, there is no concept of retirement from the employment to which the pension relates.

6. Although pension sharing applies equally to both men and women, because of the current distribution of pension rights, most beneficiaries of a pension derived from a pension share are likely to be women.

Tax issues

7. In most cases the pension rights under consideration at the time of a divorce will be tax approved pension rights. Pension schemes seeking Inland Revenue (IR) approval or continuing approval must include provision in the scheme rules for dealing with pensions on divorce. No special tax reliefs are given for divorcing couples.

8. In order to preserve the integrity of the financial settlement, pension credit benefit is not subject to the IR benefit limits. If this is not maintained the value of the financial settlement under the Court order could be eroded, recreating an imbalance in the settlement which the pension sharing provisions were designed to avoid, or the value of the settlement would erode any pension rights the pension credit member had acquired in his/her own right as an employee. In either case, pension provision would be reduced.

9. Currently there are restrictions in IR rules on ‘rebuilding’ pension value subjected to a sharing order. The tax simplification proposals introduce the concept of a lifetime limit. Under these proposals someone who transfers pension rights on divorce to a former spouse will have his or her lifetime limit reduced by the value of the transferred rights. This means that the restrictions on rebuilding as currently understood will change. Members would be able to rebuild their tax-relieved pension value within the reduced lifetime limit.

Simplification measures already taken

10. A new category of pension scheme member was introduced, namely that of “pension credit benefit member”. Pension credit benefit is derived from the value of the share allocated to the former spouse. Differentiation is to ensure that the value of the financial settlement is maintained, that IR benefit limits are disapplied to the pension credit benefits and that contracted-out and state scheme benefits are dealt with in a way which does not unfairly prejudice either the divorcing couple, the tax/National Insurance contribution payer or other scheme members.

11. The cash equivalent transfer value is the standardised valuation method. This aims to ensure that the scheme cannot pay out more than it has available at the time of divorce.

12. Specifications on procedure and timings for dealing with pensions were brought into line with those for dealing with the divorce and overall ancillary relief procedures.

13. Some rules applicable to pension benefit generally are modified in respect of pension credit benefit. For example:

- the age from which pension credit benefit can be paid from an occupational scheme is standardised at (normal benefit) age 60-65; this is inconsistent with the personal pension and state pension position;
- pension credit benefit is not subject to the IR benefit limits as it is derived from the financial settlement. Where the 'pension credit benefit' member is also an employee, the pension credit benefit is not taken into account for the purposes of IR occupational pension scheme benefit limits, provided scheme provisions treat it separately from benefit from employee rights;
- schemes are left free to decide whether or not to have any pension credit benefit members in their scheme;
- (at their specific request to ease administration) schemes are left free to decide what benefit package to offer to scheme members. It does not have to mirror that for other types of members e.g. there is no requirement for survivors' benefit to be provided;
- where pension share value is derived from contracted-out rights, those rights ("safeguarded rights") in the new pension benefit for the former spouse are subject to modified contracting-out rules (see Section B).
- treatment of ill health and serious illness cases is modified.

14. These measures were intended to simplify both pension and family law administration.

15. Many of the provisions were introduced to avoid inconsistencies in treatment of pension by family solicitors and Family Courts, save costs for the couple and schemes, save work for schemes in producing valuations and information and, importantly, to enable more fairer financial settlements and 'clean break' divorces

16. Options for simplification in the following areas are also being considered:

- consolidation of the pension sharing secondary legislation for England and Wales in one Statutory Instrument;
- repeal of the superfluous divorce proceedings requirements contained in Part II of the Family Law Act 1996;
- rationalisation of destinations for pension credit e.g. safe harbour products;

- removal of a (default) option regarding transfers of pensions shares out of the originating scheme;

- removal of the pension credit ill health and serious illness provisions to be consistent with the derivation of a pension share;

- removal of “safeguarded rights” requirements (see Section B on contracting out). This would result in the repeal of one set of regulations and several sections of primary legislation;

- alignment of ‘normal benefit age’ for payment of pension credit benefit in occupational and personal pension schemes; and

- rebuilding limits and therefore some tax rules may be removed in light of the tax simplification review.

17. **We would welcome views on these potential simplifications**

## PART 2: PROTECTING EMPLOYEES

## G. PROTECTION IN THE CASE OF WIND-UP

### FAIRER SHARING OF ASSETS

Rebalancing the priorities between pensioners and non-pensioners

1. Section 73 of the Pensions Act 1995 and the Occupational Pension Schemes (Winding Up) Regulations 1996 provide for a statutory Priority Order which overrides scheme rules and applies when a defined benefit occupational pension scheme - subject to the Minimum Funding Requirement (MFR) - starts to be wound up on or after 6 April 1997.

2. The current (or Transitional) Priority Order was introduced through the Winding Up Regulations to tie in with the introduction of the MFR and was intended to be replaced by the Final Priority Order on 6 April 2007.

*Transitional Priority Order*

3. After meeting scheme expenses and debts to third parties, the Transitional Priority Order is:

a. Additional Voluntary Contributions;

b. pensions or other benefits in payment;

c. accrued contracted-out rights (including safeguarded rights relating to pension credits - under the pension sharing on divorce legislation - and refunds of contributions to members with less than two years service);

d. pension increases in relation to b. above;

e. pension increases in relation to c. above; and

f. any other liability for accrued benefits and future benefits relating to pension credits (including pension increases).

*Final Priority Order*

4. After meeting scheme expenses and debts to third parties, the Final Priority Order is:

a. Additional Voluntary Contributions;

b. pensions or other benefits in payment;

c. accrued pension or other benefits, future benefits relating to pension credits, and refunds of contributions to members with less than two years' service; and

d. pension increases in relation to b. and c. above.

*Options for change*

5. Where schemes are wound up under-funded and scarce assets have to be distributed, the Government believes that it is right for a statutory priority order to stipulate how those assets should be shared. **Therefore, we propose to retain a Priority Order within legislation.**

6. Currently, pensioner scheme members are ranked higher than non-pensioner members in the priority order. Broadly speaking, all non-pensioners rank equally, irrespective of their age or length of time in the pension scheme. It has been suggested that there is a case for revisiting the priority order to consider whether it is as fair as it could be. **Therefore, we would welcome views on the possibilities of:**

- **increasing the priority given to people who are approaching retirement age;**

- **basing the level of protection on the number of years the individual has contributed to the scheme, irrespective of age[11].**

7. For example, people within ten years of a scheme's normal retirement age could be given higher priority than they have now. However, this approach could mean less protection for younger members, some of whom might have been contributing to the scheme for many years.

8. The options described above would be more generous for older workers or those who had been contributing to the pension for a long time. An alternative approach would aim to achieve **a fairer sharing of assets between those with larger and smaller pensions**, probably adjusted to reflect length of time in the scheme. For example, we are aware of cases in which senior figures in companies have taken early retirement only shortly before a company becomes insolvent and its under-funded scheme is wound up. In such cases, large pension payments to these individuals can strip significant assets from the pension fund, leaving those who have not retired with little or no pension. This is unjust. We could **introduce a capping system to discourage such practices**. If there were insufficient assets to meet all liabilities, pensions of such early retirees could be fully protected up to a certain level, but amounts above this cap would be returned to the pension fund to be shared out among workers who might otherwise see their pensions much reduced.

9. For example, the pensions of people who had taken early retirement within, say, the 12 months preceding the start of the wind-up of their scheme would be capped at a certain level; for example, £30,000 a year. Under this arrangement:

- people with pensions up to £30,000 a year, would retain their pensioner status and high position in the priority order (having that £30,000 fully protected); but

- people with pensions in excess of £30,000 a year who had retired within the 12 months preceding the start of the wind-up, would retain their pensioner status for

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[11] Proposal by the Rt Hon Frank Field MP.

the first £30,000 of their pension, but for any pension in excess of £30,000 they would be treated as a non-pensioner.

10. Even where such early retirement is not the issue, there might be a case for re-examining the balance of protection between the better off and the less well off. For example, the pensions of all pensioners would be capped at, say, £30,000 whenever they had retired. Under this arrangement:

- people with pensions up to £30,000 a year, would retain their pensioner status and high position in the priority order (having that £30,000 fully protected); but

- people with pensions in excess of £30,000 a year, would retain their pensioner status for the first £30,000 of their pension, but for any pension in excess of £30,000 they would be treated as a non-pensioner. They would only qualify for pension in excess of £30,000 if and when the full-accrued rights of actual non-pensioners had been met.

11. **We would welcome views on these two options.**

*Conclusion*

12. The options described above would have the advantage of sharing out pensions in ways that would give more protection to some non-pensioners. However, any changes to the priority order have the disadvantage of reducing protection for some scheme members. **We would welcome views on the advantages and disadvantages of the individual options described above and on the possible combination of options that could be implemented.**

## AMENDING THE PRIORITY ORDER OF CREDITORS

13. When a company becomes insolvent pension debts arising from unpaid contributions (up to certain limits) in respect of both defined benefit and defined contribution schemes may be claimed from the National Insurance Fund through the Redundancy Payments Service.

14. When the Redundancy Payments Service has made a payment into the resources of a pension scheme, the right to recover the relevant contributions from the insolvent employer's assets transfers from the pension scheme to the Secretary of State and may be recovered as preferential debts. The contributions that rank as preferential debts are:

a. employee contributions: any amounts deducted or due from wages paid or payable in the four months prior to the employer's insolvency and not paid over to the occupational or personal pension scheme;

b. employer contributions: contributions due to be paid to a contracted-out occupational pension scheme over the 12 months prior to the employer's insolvency. The amount depends on the contracted-out status of the member's employment:

i. if contracted out on a salary-related basis, the amount of contributions required to secure Guaranteed Minimum Pensions;

ii. if contracted out on a money purchase basis, contributions owed for the employer's minimum payments in respect of the employee.

15. Apart from in the above circumstances, pension schemes are categorised with unsecured creditors at the bottom of the list of creditors that can make a claim on an insolvent employer's estate, beneath preferential creditors (such as unpaid wages) and secured creditors (which include banks, mortgage lenders and so on who had made secured loans). Some argue that pension scheme members should be given the same priority as preferential or secured creditors.

16. This would increase the overall level of funds available to schemes. However, it could also have significant wider economic consequences. In particular, employers with defined benefit schemes could find it harder to obtain secured loans, or see the cost of those loans increasing. So this is very unattractive.

17. One way of addressing this problem might be **to create a new category of creditor**. Pension schemes could be given a higher priority than other unsecured creditors but still have lower priority than preferential and secured creditors. This would reduce the potentially adverse economic effects. However, other unsecured creditors – for instance trade suppliers, consumers and employees – would lose out. They might consider they have at least as much right as a pension scheme to a share of the insolvent employer's assets. As a result, some - such as trade creditors – might have to downsize or go into insolvency themselves. **We need to strike a careful balance between the potential impact on business and the need to provide adequate protection for members. We would welcome views on this balance.**

## INSOLVENT EMPLOYERS

18. As noted in the Green Paper, another approach to dealing with defined benefit schemes that are under-funded when the employer becomes insolvent would be to introduce some form of **insurance or a centralised 'clearing house' arrangement**. Following a number of scheme wind-ups, the Government wants to look again at whether this might be a practical way of reinforcing the pension promise. Some form of insurance might be attractive to scheme members as it would give them greater confidence in the benefits promised.

19. There are a number of different approaches that could be taken here, for example:

- a centralised arrangement or 'clearing house' into which people whose employer became insolvent could pay the funds they receive on wind-up. The clearing house could then seek to buy on their behalf the best available annuity from an insurance company; and

- a form of insurance (possibly a Central Discontinuance Fund (CDF)) that enables members to be more confident that, if their employer becomes insolvent with an under-funded pension scheme, they will receive the benefits promised.

Centralised clearing house arrangements

20. When a defined benefit scheme winds up, if working-age members wish to obtain an alternative guaranteed retirement income with the funds that they receive, they must purchase a deferred annuity. But typically, deferred annuities are expensive, especially for younger members. These costs lead to lower pensions.

21. In part, the high costs of deferred annuities reflect the fact that the provider is being asked to assume a significant amount of risk over a long period of time. But it also reflects the fact that the deferred annuity market is under-developed, and that administrative costs are high and trustees' negotiating position weak, especially when schemes are small or they are acting individually.

22. **We are therefore interested in considering the establishment of a central fund into which members could choose to pay the funds that they receive on wind-up. The fund could then – acting as a whole – negotiate the purchase of deferred annuities with providers.** Members facing wind-up might expect to get a better deal because it would become more attractive to provide deferred annuities: administrative costs would be more widely shared and risk would be more widely pooled. In addition, trustees' negotiating position would be strengthened by their coming together in a single fund.

Insurance arrangements

23. **Another possibility would be to introduce an insurance scheme**, perhaps a CDF, providing pensioners and non-pensioners with greater protection against the possible pension implications of insolvency. Different models would offer differing degrees of benefit-replacement and guarantee. The additional protection could be funded by, for example, a reduction in pension benefits or increased contribution rates. The cost would need to be balanced against the greater overall level of security offered.

24. **We would welcome views on these options and their potential impact.**

## IMPROVED COMPENSATION ARRANGEMENTS

25. People need to be protected against dishonesty. The current Compensation Scheme was established by the Pensions Act 1995 and provides compensation for losses caused by dishonesty where the employer is insolvent. It is financed by a levy paid by occupational pension schemes.

26. There are currently restrictions on the amount of compensation that can be paid in cases of dishonesty. For defined benefit schemes, it is restricted to the amount needed to bring the value of the scheme's assets up to 100 per cent of its liabilities for pensioners and members within ten years of retirement, and 90 per cent of its liabilities for other members or, if lower, the amount of the actual loss. For defined contribution schemes, compensation is limited to 90 per cent of the loss.

27. **We propose to remove these restrictions so that schemes with an insolvent employer can be compensated for the full amount lost as a result of acts of dishonesty.**

## SOLVENT EMPLOYERS

28. Some solvent employers choose to wind up their pension schemes. When they do this they need to make arrangements to meet the pension promise they have made to their past and present employees. There have been instances recently in which members have lost out substantially under these circumstances. The Government believes that members need greater protection against such losses.

29. Section 75 of the Pensions Act 1995 and the Occupational Pension Schemes (Deficiency on Winding-Up etc) Regulations 1996 contain the provisions on the calculation of the assets and liabilities of a pensions scheme that is winding up in order to establish whether there is a debt on the employer. The purpose of the provisions is to ensure that when schemes are wound up, either by a solvent employer or as a consequence of insolvency, employers are made liable for the debts they owe to those schemes.

30. In March 2002, we increased the amount of money that solvent employers have to put into the pension fund if they choose to wind up the scheme. This means that employers are required to put enough money in to cover:

- the trustees' estimate of all expenses likely to be incurred when winding up the scheme;
- the actual costs of buying annuities with an insurance company for pensioners (guaranteeing their full pension); and
- for people who have not retired, the value of their accrued benefits, worked out on the MFR basis (which they can transfer to another pension arrangement).

31. In this last case, the transfer value does not guarantee the full pension they were expecting as the transfer value is calculated by making assumptions about the level of investment growth between the time of wind-up and when the individual retires. If investment growth is more or less than assumed then the value of the pension fund at retirement could be similarly greater or smaller. With transfer values, therefore, the risks are borne by the individual; and

32. After the replacement of the MFR with scheme-specific funding requirements (see Section A), it will be for schemes to determine their own transfer values on a basis that is fair to all. As the MFR has provided a minimum measure of funding, we might expect that in many cases transfer values would be higher than the minimum amount that they were under the MFR.

33. While this change provides more protection than before, some have argued that there is a case for strengthening these arrangements further. Two options that have been suggested are:

- a **'full buy-out'** where employers would be required to provide sufficient funds on wind-up to allow all scheme members to buy annuities (deferred in the case of non-pensioners) which could guarantee their full pension; or

- a **'partial buy-out'** where the amount of money in the scheme would provide full protection for pensioners and those nearing retirement. Younger workers would receive cash equivalent transfer values as now.

34. Both these options would increase the likelihood of members getting the pension they had been promised. However, at the moment there is only a small market in deferred annuities and this can work against individual choice and the market competitiveness that gives individuals good value. These options could also increase costs to employers, including those that have no intention of closing their scheme. **We can see arguments for and against increasing the amount that employers are required to put into the pension fund if they choose to wind up the scheme. The Government will be guided by the aim of not increasing the overall burden on employers providing pensions.**

35. **We would welcome views on the appropriate balance to strike here.**

**SPEEDING UP WINDING UP**

36. In April 2002 we introduced new legislation that places greater visible accountability on those people whom are involved in winding up a pension scheme. The legislation:

- requires trustees to make regular progress report to the Occupational Pensions Regulatory Authority (Opra);

- allows Opra to direct that action be taken by those responsible if it considers that the winding up is being unreasonably delayed;

- requires other people involved in running a scheme to tell Opra if there are no trustees so that consideration can be given to appointing a trustee; and

- allows trustees to apply to Opra for an order to modify a scheme so that it can be wound up properly.

37. We will continue to review these new arrangements and to see what else, if anything, needs to be done to ensure that members receive their benefits as soon as possible.

38. Some of the options discussed in this paper might help to speed up winding up. For example, the Pickering Report suggested that addressing the issue of Guaranteed Minimum Pensions could speed up the process of winding up. **However, we would welcome any suggestions on how winding up could be further speeded up.**

39. **We would also welcome views on the Pickering Report's proposal to allow liabilities on wind-up to be discharged to a stakeholder pension or other defined**

**contribution vehicle provided the member does not object and provided the person was over ten years away from normal retirement age.**

## H. TRANSFER OF UNDERTAKINGS (PROTECTION OF EMPLOYMENT)

1. The Transfer of Undertakings (Protection of Employment) (TUPE) Regulations[1] are designed to safeguard employees' rights when businesses transfer between employers but they exclude rights in respect of continuing active membership of an occupational pension scheme[12]. Therefore, simply as a result of a transfer, an employee's future pension rights can be significantly reduced; in particular, any employer contribution can be entirely withdrawn.

2. In September 2001 in the TUPE consultation paper *Government Proposals for Reform* we sought views on the provision of explicit legal protection for employees' occupational pension rights on transfer, including within the private sector. Those respondents who favoured such an approach outnumbered by around three to two those who, either explicitly or by implication, favoured the alternative of confining protection to the public sector by virtue of the long-standing policy in this sector[13]. The former group included the TUC, a number of individual unions, and some employer's organisations (e.g. the Heating and Ventilating Contractors' Association, the National Association of Regional Employers, the Employers' Organisation for Local Government) and individual employers (e.g. the Ford Motor Company, EDS, Unilever UK, EDS and Accord plc). The latter group included the CBI, the EEF and a number of other employers' associations and individual employers.

3. In the Green Paper the Government is not proposing to set a general minimum level of employer contributions to pensions. Under TUPE, the pay of transferred employees cannot be lawfully changed by reason of a transfer. TUPE does not at present cover pensions. However, as a matter of policy the Government extends similar protection to pensions in the case of public to private transfers. Many private sector employers also provide a degree of continuity in occupational pension entitlement across a TUPE transfer.

4. The impact of any such protection would thus be on the minority of cases where that would not otherwise happen. Such a provision might help to avoid disputes concerning business transfers; create a level playing field for competition; and "take the fear out of transfer" for affected employees. Others argue that additional protection means additional costs for employers and may lead them to scale back their provision of pensions. The new employer would have the same leeway as the old employer to vary or even end such provision, so long as the reason for doing so is not the transfer, meaning such a reform would not involve introducing compulsory ongoing employer pension contributions for transferred workers.

5. A detailed background paper[3] published alongside the September 2001 consultation document set out a number of (non-exhaustive) options for possible mechanisms by

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[1] Transfer of Undertakings (Protection of Employment) Regulations 1981.

[12] Accrued rights, on the other hand, are clearly protected under pensions legislation, and this will remain the case.

[13] As noted in the Green Paper, the Government remains committed to the long-standing policy of protection on a 'broadly comparable basis' for public sector transfers, both on initial transfer of a service to the private sector and on any subsequent transfers within the private sector.

[3] *Transfer of Undertakings (Protection of Employment) Regulations 1981 – Government Proposals for Reform – Detailed Background Paper* (URN 01/1158).

way of which protection might be provided for the economy as a whole. There was however a mixed response to those options. A number of key themes and messages have been identified from the consultation document responses. These may be summarised as follows:

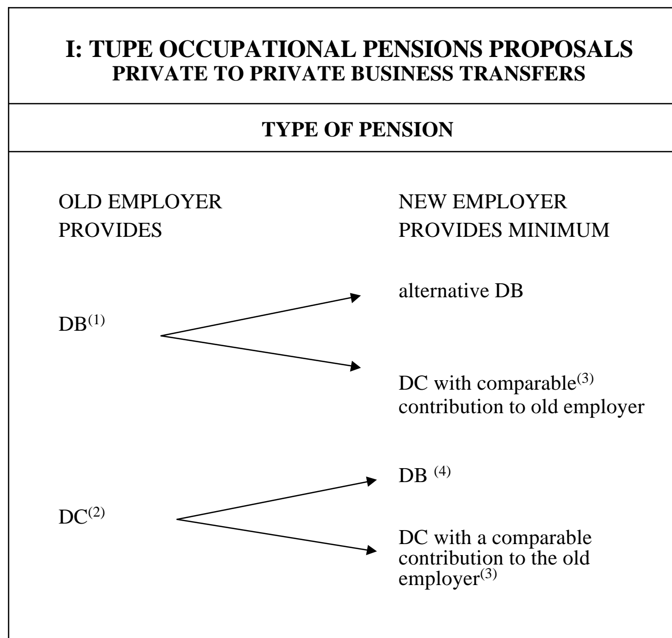
- If protection is to be provided, it should be worthwhile for the employees concerned. It should not be so weak as to risk encouraging the new employer to use the transfer as a pretext for reducing rights to the specified minimum level of protection.

- Any new legislation should be kept as simple and flexible as possible. Such an approach would be in line with the overall thrust of the Government's policies in this area, and should minimise costs on employers by, for instance, avoiding as far as possible approaches that would require significant additional actuarial work to be carried out.

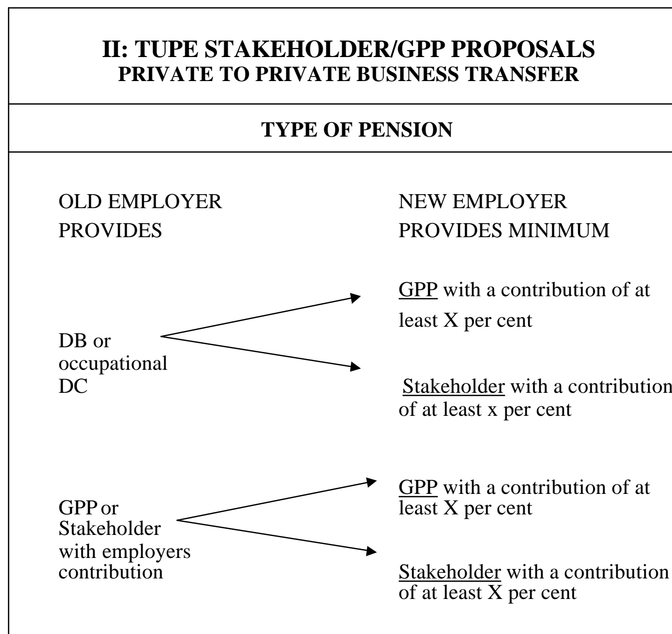
- Any new legislation should be seen as a "safety net" for those employees who would otherwise be seriously disadvantaged in the transfer, and should avoid cutting across current good practice. For example, it should not interfere in cases where the new employer voluntarily offers transferring employees access to the same (good quality) pension scheme as his or her existing staff – or the public sector policy. It should not prevent or discourage the new employer from making provision more favourable than the statutory minimum, if he or she wishes to do so.

- As under the public sector policy, the new employer should be permitted to pay transferred employees adequate alternative compensation in exceptional circumstances where it is not reasonably practicable to meet the normal requirements. Such circumstances could arise, for instance, where only a small number of employees were involved in the transfer and there was no existing pension scheme to which they could be offered membership, or where the transferee was a small employer.

6. Were the Government to extend a degree of protection for occupational pension rights to purely private sector transfers, such protection would need to be simple, flexible and worthwhile. Two possible options for extended protection that might fulfil these criteria are set out below. Both would ensure that where the previous employer made a pension contribution, so too would the new employer. It is assumed that following the transfer, the employer would be at liberty to modify the provision should this become necessary for reasons unrelated to the transfer itself.




Notes: [1] DB = defined benefit.
[2] DC = defined contribution.
[3] Adjusted if necessary for the loss of National Insurance rebate if contracted-in and where comparability is determined over the lifetime of the fund.
(4) under contracted-in schemes, members would also qualify for State Second Pension.




(5) GPP = Group Personal Pension.

7. **We would welcome comments on this general issue and on these suggested proposals. In the context of Option II we would welcome suggestions on the employers' contribution rates (including levels and age-related contributions) when the new employer provides a stakeholder or Group Personal Pension scheme.**

8. When considering suggestions, we will also take particular account of the following:

- support for business flexibility;

- genuine and worthwhile protection for employees against the insecurity this creates on the transfer of an undertaking.

## I. MEMBER-NOMINATED TRUSTEES – ABOLITION OF EMPLOYERS' OPT-OUT

1. The Government introduced changes to the member-nominated trustees (MNTs) requirements in the Child Support, Pensions and Social Security Act 2000 following a period of public consultation. Those changes, which removed the employers' right to opt out of having MNTs, have not yet been commenced. Nevertheless, we remain committed to the principle of those changes. We want more members to be involved in the running of their pension schemes, and we plan to remove the employers' right to propose an opt-out.

2. We believe that having member trustees on the boards of occupational pension schemes helps give members a sense of involvement, and increases member confidence. It can also help to raise the standards of governance.

3. Removing the employer opt-out would also help to make MNT arrangements simpler for schemes to operate and we discuss simplification in relation to MNTs in Section C.

## PART 3: PROMOTION OF PENSIONS

## J. IMMEDIATE VESTING

### EXISTING PROVISIONS

1. Individuals must be a member of an occupational pension scheme for a minimum of two years before they secure any entitlement in law, unless scheme rules specify a shorter period. This is known as the vesting period. Schemes can impose shorter vesting periods and some may have no vesting period at all. Early leavers who leave the scheme before their rights vest can have their contributions refunded (less any tax due). Individuals whose rights have vested do not have a right to a refund of their contributions. Personal pensions, money purchase contracted-out scheme rights and stakeholder pensions all vest immediately.

2. Individuals who change jobs frequently can have many years of cumulative pensionable service in pension schemes but no accrued rights because they leave before the rights vest. Contributing to the pension scheme effectively becomes a short-term savings plan.

3. However, once the rights vest schemes may have lots of small amounts of accrued rights to manage for years. Employers who currently want to avoid that burden on their schemes arrange for scheme rules to impose the maximum vesting period allowed in legislation which is two years.

### OPTIONS FOR CHANGE

4. The Pickering Report recommended that all rights should vest immediately. The advantage of immediate vesting for employees is that individuals would be able to accrue rights to a pension in circumstances where they might not now be able to do so. A drawback for employees who change jobs frequently is that potentially small amounts of pension rights would be accrued in a number of different pension arrangements. However, as now, if individuals wanted to consolidate all their pension entitlements accrued in different schemes they can do so by transferring them into a personal pension plan or stakeholder pension of their choice (the latter without any "one–off" financial cost, although it would still incur charges of up to one per cent a year).

5. **We propose requiring that rights in all schemes should vest immediately with the proviso that *de minimis* amounts can be transferred without consent (Section K). We would welcome views.**

## K. TRANSFERS WITHOUT CONSENT

1. As a counterbalance to the additional burdens that immediate vesting would create, the Pickering Report suggested that it be coupled with an easier way for rights to be transferred out of the scheme when an employee leaves.

2. Transfers of vested rights from ongoing schemes on an individual basis can normally only be made with the member's consent. If members do not ask the trustees to transfer their rights out of the scheme when they leave employment, the scheme would have to retain the rights until the individuals reach scheme pension age. In the context of its recommendations on immediate vesting, the Pickering Report recommended transfers without consent of *de minimis* amounts - perhaps less than £10,000 - to a default stakeholder pension, if the early leaver does not take a voluntary transfer to an arrangement of their choice within a set period. It suggested that this period be set at six months following the date of leaving employment.

3. This raises an important issue for members of defined benefit schemes. The move to a stakeholder pension represents a shift away from the pensions promise in the defined benefit scheme, with the employer bearing the investment risk, to one where the member bears all the investment risk. If their rights could be transferred without their consent it would be important that members were made fully aware of the position at the time they left the scheme and that they needed to take action if they did not want the transfer to take place. The Pickering Report suggests that members be given suitable information about the stakeholder scheme in the form of key features documents required under the Financial Services Authority rules. Should transfers without consent be introduced, this would seem to be an appropriate suggestion.

4. Good communications with members would be vital and they would need to be told, at the outset, what could happen when they left the scheme, including where their rights would go, and would need to be reminded again when they actually left. Members approaching pension age might need to be warned to take advice. If members were told when they left the scheme that their rights would be transferred out of their scheme to a stakeholder scheme after six months unless they objected, then it would be up to the members to take action if they were not content with that arrangement. However, if they were not given that information before they left, consent would need to be obtained before any transfer could be made. This would provide added protection for members who, not unreasonably, left their rights in the scheme expecting them to remain there until they became payable.

5. In the context of a requirement for immediate vesting in all pension schemes we see merit in allowing trustees of occupational pension schemes to be able to transfer without the consent of the member. **We therefore propose that trustees of occupational pension schemes should be able to transfer *de minimis* amounts to a stakeholder pension where members left the schemes more than six months previously, providing the members do not object, were aware of the proposal to do so at the time they ceased to participate in the scheme, and do not ask for the rights to be transferred elsewhere.**

6. The Pickering Report suggested that the level of the *de minimis* amount should be subject to consultation. £10,000 potentially represents a significant number of years of pensionable service in a defined benefit pension scheme depending on the member's sex, age and earnings. The number of years that amount represents would also depend on the scheme's benefits, including the normal retirement age, and crucially on the assumptions used by the scheme in calculating cash equivalent transfer values. In the following examples the accrual rate is one sixtieth for each year of pensionable service, and a pension age of 65 is used. For example, for a man on a salary of £15,000 per annum at age 40, £10,000 might represent just under six years' accrued rights (or as much as nine years if transfer values were calculated according to the current minimum basis). For someone on lower earnings, say £10,000, the same *de minimis* amount could represent just about nine years' worth of accrued rights. For older members and those with higher salaries it would represent fewer years of pensionable service. For a man aged 50 with a salary of £40,000, the sum of £10,000 might still represent just over one and a half years' pensionable service.

7. Although we want to introduce flexibility for occupational pension schemes, this needs to be balanced with protection for scheme members. A lower *de minimis* amount would reduce the number of past years service which would be converted without consent to an arrangement where the investment risk shifts on to the individual, and would offer some protection to members who had participated in a defined benefit scheme for some years.

8. A *de minimis* amount at a lower level, say at £7,000, would reduce the risk of low to moderate earners being transferred out when they have significant periods of service in the scheme. However, it might still represent six years' service for a man aged 30 earning £15,000 a year. For someone of the same age earning £20,000 the equivalent period is about four years. However, those individuals would have a minimum of a further 30 years or so to build on the amount transferred.

9. Another approach would be to allow trustees to transfer rights of, say, less than five years. This would limit the period of past service which would be converted without consent to an arrangement where the investment risk shifts on to the individual, and would mean that, irrespective of the persons age or salary, the maximum period of defined benefits rights which could be transferred would be the same.

10. **We would welcome views on whether a *de minimis* amount of, say, £7,000 or alternatively a period of five years service in the scheme should apply.**

11. **We would particularly welcome comments from stakeholder pension providers and insurance companies on this option. Would there be any benefit in requiring the trustees of each pension scheme to nominate a single stakeholder scheme for all transfers unless the deferred member nominates another, or would that happen anyway? We would also be very grateful for any further comments on the option.**

## L. ALLOWING COMPULSORY SCHEME MEMBERSHIP

1. Since 1988 employers have not been able to make membership of their occupational scheme a condition of employment.

2. Indications are that only about 72 per cent of all employees who are eligible to join a pension scheme provided by their employer do so. Those who work for short periods of time may feel that it is not worth their while to join a scheme, others may decide they cannot afford the contributions. And some employees may not be sufficiently proactive to take positive action to join the scheme even if they are eligible to do so.

3. The Pickering Report recommended allowing employers to make membership of their pension scheme a condition of employment for all new employees, including all employer-sponsored pensions such as stakeholder pensions and group personal pensions, as well as occupational pensions, but only where the employer is making a contribution of at least four per cent of pensionable pay.

4. We support employers who provide pensions and we want to ensure that as many employees as possible participate in these schemes. Compulsory membership would not be appropriate for every occupational pension scheme. Some employers, for example those with a significant number of low earners in high turnover jobs, may feel that it would not be appropriate to introduce compulsory membership of their schemes, but others may take a different view.

5. The most important benefit of allowing employers to make membership of the scheme a condition of employment for new employees would be that the employee would be accruing pension rights in the scheme where they might not have done so had they been required to take the initiative. In addition, a member of an occupational pension scheme would have the benefit of the employer meeting administration costs as well as paying a contribution.

6. Some individuals may have decided that a personal or stakeholder pension is the most suitable form of pension arrangement for them and they may not want to, or be able to afford to, contribute to two forms of pension arrangement at the same time. Some personal pension plans may allow individuals to stop and start the payment of contributions without penalty (stakeholder schemes are not allowed to impose a penalty if contributions cease) but others may impose penalties when contributions cease.

7. Compulsory membership may, therefore, have to make some allowance for those who cannot, or do not wish to, contribute to two forms of private pension provision. In those cases employees who were contributing to a personal pension arrangement or a stakeholder pension would be able to opt out of their employer's pension scheme, whether it is an occupational or a personal pension, thus allowing them the flexibility to continue to contribute to their chosen personal pension arrangement.

8. This approach would not preclude employees from joining the scheme where they wanted to. Individual employers would be left to decide what level of documentation

employees would need to satisfy the conditions for opt-out and might suggest that individuals seek independent financial advice before choosing to opt out.

9. There might need to be wider provisions for opting out. Some people may generally prefer not to contribute to their employer's pension scheme and object to having to tell their employer how they save. On the other hand, a wide opt-out provision might defeat the object, leading to no or only a very small increase in individuals taking up the opportunity to join their employers' pension scheme.

10. **We are considering options for employers, on a voluntary basis, to be able to make membership of their scheme a condition of employment for all new employees. We propose that employees should be able to opt out of the scheme where, for example, they are already contributing to a stakeholder pension. We would welcome views, for example on how broad the opt-out should be.**

# PART 4: PARTIAL REGULATORY IMPACT ASSESSMENT

1. The purpose of this document is to provide an initial assessment of the impact that proposals would have on businesses and individuals.

2. Discussion of all policy proposals includes some broad figures on the impact of these measures on private sector schemes. Quantifying their impact is very challenging. It is difficult to predict precisely external factors such as the state of the global economy. Also many of these proposals would have an impact on people's behaviour but it is difficult to predict by exactly how much. And some of the proposals would affect the administrative costs of running schemes – we have very limited information about this and we would welcome the input of businesses in this area, in particular.

3. We would welcome your views on this Partial Regulatory Impact Assessment, both in general and on the specific questions asked. In particular we would be interested in the views of small and medium sized businesses on the impact these options might have on them.

## SUMMARY OF FINDINGS

4. The summary that follows covers all policy proposals covered in the Green Paper "Simplicity, security and choice: Working and saving for retirement" and the accompanying technical paper – "Simplicity, Security and Choice: technical paper."

## SUMMARY OF FINDINGS - SAVINGS

5. The proposals which would be likely to have the biggest effect in terms of providing on-going administrative savings for those running pension schemes are:

   - tax simplification;
   - replacement of the Minimum Funding Requirement (MFR);
   - simplification of contracting out;
   - removal of prescription on the selection of member-nominated trustees (MNT);
   - move from a two-stage to a one-stage internal dispute resolution system;
   - less prescription on communication with scheme members;
   - easier transfers of small amounts of pension; and
   - changes to restrictions on powers to alter schemes.

6. The proposals which, if implemented, could have the biggest effect in terms of producing ongoing funding savings for employers are:

   - a lighter contracting out test;
   - abolition of compulsory indexation of pensions;
   - abolition of compulsory survivors' benefits for contracted-out schemes; and

- savings resulting from the effect of MFR replacement on schemes' investment strategies.

**Administration Savings**

7. Informal soundings with pensions experts suggest that for the largest schemes (those with over 40,000 members), the average administrative cost is around £28 per member per year. For smaller schemes (those with fewer than 500 members), the cost is around £80 per member per year.

8. We have been able to estimate the administrative saving of some of the individual proposals, but not all. Those we have been able to estimate are replacement of the MFR (on going savings of £10 million a year across all pension schemes), removal of prescription on the selection of member-nominated trustees (on going savings of £20 million a year across all pension schemes) and tax simplification (on going savings of at least £80 million a year).

9. We have not been able to estimate the saving of the other individual proposals, but a very rough estimate of the net effect of them is that they could save in the region of £40-80 million a year.

10. So, if all the measures were to be implemented, this could save employers £150-200 million a year in administration[1].

**Funding Savings**

11. The options that could affect funding are voluntary measures for businesses. All the measures would allow employers to choose whether or not they wish to make changes to their pension schemes[2].

12. The options to lighten the contracting-out test, both by switching from pension based on final salary to career average and by reducing the accrual rate from 1/80th a year to 1/100th a year, could save companies with defined benefit schemes up to around 30 per cent of their contributions. Some schemes that decide not to provide indexation of pensions (which is not restricted to contracted-out schemes) would save roughly 20 per cent of their contributions. Some schemes choosing not to provide survivors' benefits would save 20 per cent. All these estimates should be taken as a broad order of magnitude only, and the savings each firm might make would depend on the composition of the staff and whether or not they choose to reduce the level of benefits they offer. The removal of compulsory provision of indexed benefits for pensions of up to £30,000 a year could save some firms a small proportion of the cost of contributions, while ensuring the value of smaller pensions are preserved through retirement. We would welcome the views of business on this last option.

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[1] £10 million for MFR, £20 million for MNTs, at least £80 million from tax changes and £40-80 million of savings from all the other changes.

[2] It should be noted that one of the options, discussed later, is to ensure that employers consult with employees or their representatives before making changes to the pension scheme.

13. We estimate that the effect on investment strategies of the MFR replacement might be in the region £70 million a year across all pensions schemes.

14. There are number of important points to note:

   i) The majority of contracted-out schemes provide pensions in excess of the requirement of the contracting out test. And the limited evidence we have suggests that the majority of schemes would continue to provide indexation (which is not limited to contracted-out schemes) and survivors' benefits, so it may be that only fairly small funding savings would actually result across the whole pension's industry.

   ii) We do not know what the behavioural effect would be in terms of how firms would react. For example, we do not know how many businesses would keep their defined benefit schemes open who might otherwise have closed them down. We welcome any evidence about the likely behavioural response of employers.

   iii) In terms of funding, we recognise that any savings to firms represent lost benefit for members. However, we also want to evaluate the evidence as to whether these reforms might encourage firms to maintain schemes that they might otherwise close. Only if we believe that these options will lead to more pension provision overall than would otherwise be the case would we consider implementing them.

**SUMMARY OF FINDINGS – COSTS**

15. The proposals if implemented, which would be likely to have the biggest effect in terms of ongoing administrative costs for those running pension schemes are:

   - a statutory requirement to consult with scheme members or their representatives before making changes to the pension scheme;
   - a new pensions regulator (leading to an increase in the levy which funds the regulator);
   - provision of combined pension forecasts;
   - provision of pensions information on total benefit statements, pay slips and job advertisements;
   - extension of requirements in relation to trusteeship (implementation of the Myners' proposals); and
   - possibly immediate vesting, although the allied proposals of easier transfers of *de minimis* amounts of pension might more than offset any extra costs.

16. The options which, if implemented, could have the biggest effect in terms of ongoing funding costs for employers are:

   - increased compensation for scheme members in cases of loss through fraud or theft;

- immediate vesting; and
- strengthening the debt on the employer in the case of a scheme winding up.

17. We also consider the option of some form of insurance or central clearing house arrangement. A central clearing house would involve minimal administrative costs. An insurance arrangement could be funded by, for example, a reduction in pension benefits or increased contribution rates.

**Administration Costs**

18. The on-going additional cost of the new pensions regulator is likely to be in the region of £3.5 million a year, funded through an increase in the levy on occupational pension schemes. The start up cost is likely to be about £2.5 million.

19. Implementation of the Myners' proposals to require trustee training could cost in the region of £6 million a year for each of the next three years, with a small ongoing cost thereafter.

20. So we estimate that the total administrative costs of this package of proposals could be around £8.5 million in the first year[3], £9.5 million for years two and three[4] and finally an on-going cost of £3.5 million a year[5].

21. We welcome views on these estimates. In particular whether you agree that the new pensions regulator and Myners' proposals aside, the options would have minimal ongoing administrative costs (although some could involve start up-costs). These are discussed later in this RIA.

**Funding Costs**

22. We estimate the cost of higher compensation in the case of fraud or theft as negligible. It is difficult to estimate the costs of immediate vesting as this will depend on a number of factors, including current scheme rules in relation to vesting and waiting periods, and the extent of any increase in membership by new employees. In our reforms we will be mindful of the overall burden of regulation on business.

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[3] £2.5 million for the new pensions regulator start-up and £6 million for Myners' proposals.
[4] £3.5 million for the new pensions regulator and £6 million for Myners' proposals
[5] The new pensions regulator only.

# SIMPLIFICATION

## A. A NEW FRAMEWORK FOR SCHEME FUNDING

### Description

23. The Government proposes to replace the minimum funding requirement (MFR) for defined benefit occupational pension schemes with scheme-specific funding requirements - a framework for scheme funding which will offer security for members without damaging consequences for investment. This is an important measure which strikes the right balance between flexibility and affordability for employers and protection for members. Key elements of the proposal are:

- a requirement for scheme trustees to draw up a Statement of Funding Principles, based on advice from the scheme actuary, and agreed with the sponsoring employer. This will set out the scheme's strategy for funding its pension commitments and its recovery plan for eliminating any deficits.
- trustees will be required to obtain a full actuarial valuation of their scheme at least every three years. The valuation will be based on a funding approach (including actuarial assumptions) agreed with the employer following advice from the scheme actuary.
- more effective communication with scheme members. A copy of the Statement of Funding Principles will be available to any member on request. It is also proposed that trustees should be required to send regularly updated information to scheme members containing key information about the funding position of their scheme.
- the scheme actuary's duty of care towards scheme members will be clarified.

### Risk Assessment

24. The MFR has not worked as intended, and from the outset has given rise to a number of concerns. It has proved to be inflexible, and unable to reflect the specific circumstances of individual schemes. The need to satisfy the MFR test has also led some schemes to focus too much attention on the impact of short-term market conditions instead of on an appropriate strategy for meeting their specific pension commitments.

### Identification of Options

25. A consultation document was published in September 2000 inviting comments on alternative approaches to the MFR. These alternatives included principally the establishment of a central discontinuance fund, compulsory insurance or a system of prudential supervision by a regulator.

26. There was also an option for a 'one-size-fits-all' common funding standard but this was rejected because a practical regime could not be devised which would avoid the drawbacks affecting the current MFR. Furthermore, a common funding standard does not take into account each scheme's specific circumstances. In March 2001 the Government published "Security for Occupational Pensions: The Government's Proposals". This set out the Government's proposals for replacing the MFR, and the arguments for not proceeding with the other options considered during that consultation exercise.

**Issues of Equity or Fairness**

27. It is necessary to ensure that the regulatory burden on employers who choose to run defined benefit occupational pension schemes is proportionate, and to ensure appropriate protection for scheme members. The proposals for replacing the MFR, coupled with other proposals on simplification and protection, will strike that balance.

28. The proposals for replacing MFR will apply on an equal basis to most defined benefit occupational pension schemes.

**Costs including Savings and Benefits**

29. The proposals for replacing the MFR will have a financial effect on both the funding and the administration of pension schemes. There is limited information on which to base reliable estimates of the costs and benefits, and estimates must therefore be regarded with caution. Estimates will also be affected by future changes in economic conditions (such as stock market fluctuations), and changes in the number and membership of defined benefit schemes.

30. Broad estimates of the financial effects of the proposals follow.

***Scheme funding levels & correction of shortfalls***

31. There is no information on which to base an estimate of the impact of this change on assessments of schemes' funding levels. A range of assumptions is likely to be adopted, however, and the overall effect could therefore be expected to be broadly neutral. On this basis the impact on the overall level of scheme funding would be broadly unchanged.

32. There will also be an impact on the period over which schemes choose to correct deficits. The estimated total shortfall for schemes under the MFR is £25 billion[6]. If all schemes were to carry out an MFR valuation now, they

[6] These estimates are based on data collected from the actuarial profession from consulting actuaries and insurance companies on the MFR funding levels of just over 1000 schemes that had had an MFR valuation with an effective date between April 1997 and April 2000. This database may under-represent underfunded schemes and consequently these estimates may underestimate slightly the likely reduction in costs. The estimate assumes that overall the target level of funding will not change as a result of the abolition of the MFR. However it is assumed that the average period over which

would be required to make up this £25 billion deficit over a 10-year period (the MFR deficit correction period). Assuming the amounts are constant, sponsoring employers would therefore need to pay an additional £3.4 billion a year over 10 years to eliminate this MFR deficit, allowing for the interest due to the £25 billion being spread over future years.

33. There is no information on which to base an assessment of the likely period over which individual schemes will choose to correct deficits identified under the new arrangements. Estimates are therefore based on the assumption that, overall, schemes would generally revert to the typical approach used before the MFR was introduced, which involved spreading the deficits over the average remaining period of the working life of current members (around 15 years, on average, for a typical scheme). The total deficit of £25 billion would therefore be spread over 15 years instead of 10, at a rate of £2.6 billion a year. The estimated annual difference in the additional money being paid by sponsoring employers in each of the first 10 years is therefore £800 million (or around £600 million[7] net of Corporation Tax).

34. Other things being equal, however, this is neither a cost nor a saving in the long term. The actual cost of providing the pension benefits is not altered, simply the period over which they are funded. The estimate assumes that schemes would generally choose to correct funding deficits over a longer period, but any short-term cash flow saving is offset by higher aggregate payments over the long-term (schemes which put more money in now will have to put less in later, and vice versa).

***Investment strategies***

35. The removal of the MFR is expected to have an impact on schemes' investment strategies. Estimates made when the MFR was introduced assumed that it would result in a higher level of investment in gilts, and a somewhat lower level of investment in equities. Estimates about the likely impact of removing the MFR under current market conditions must necessarily be treated with caution as the approach taken to pension fund investment will have been influenced by a number of developments since the MFR was introduced. But we have assumed that there is still likely to be some reversal of the trend to higher investment in gilts caused by the introduction of the MFR.

36. The extent to which schemes might reduce their gilt weighting under current market conditions and in the light of the changes which have taken place in the last few years to pension fund investment makes any estimate extremely uncertain. However, the MFR is considered to have had an impact on the demand for gilts, and its removal is therefore likely to lead to some reversal of this trend. At present it is estimated that schemes, in total, have some £100

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underfunding will be corrected when schemes are able to approach this on a long-term, scheme-specific basis will increase from the currently required 10 years to an average of 15 years.

[7] This makes allowance for Corporation Tax at a rate of 30%. This rate would reduce for less profitable companies that might be more likely to be associated with underfunded schemes. This will also mean that the figures presented may underestimate the likely reduction in costs.

billion invested in gilts. On the assumption that 5 per cent (£5 billion) of this was switched to equities following the removal of the MFR, and that an extra two per cent rate of return was achieved on those assets as a result, the extra investment income would amount to £100 million, or around £70 million net of corporation tax.

*Removal of MFR valuations*

37. In addition to MFR valuations, schemes are required under existing rules to obtain ongoing valuations. Estimates assume that the cost of the scheme specific valuations required under the new regime will be broadly the same as the cost of the current ongoing valuations. The preparation of schedules of contributions will also continue broadly as now.

38. Estimated administrative savings in this area will therefore flow solely from the removal of the requirement to carry out MFR valuations. There are around 40,000[8] defined benefit occupational pension schemes currently subject to the MFR (this includes schemes that are open, closed, frozen and winding up). The typical cost of an MFR valuation for larger schemes is estimated to be around £10,000. MFR valuations will, on average, be considerably less expensive for smaller schemes, since many of these are insured schemes, with simpler scheme administration arrangements and, consequently, significant economies of scale. Assuming £10,000 as an average administrative saving for the 5,000 schemes with more than 100 members, and £2,000 as an average for 35,000 smaller schemes, the total estimated savings over the normal 3 yearly valuation cycle amount to around £120 million (£50+£70 million). This is equivalent to annual savings of around £40 million a year, or around £30 million net of corporation tax.

*Annual recertifications*

39. Under the MFR, schemes were required to carry out an annual re-certification of their funding position between each full three yearly valuation. In March 2002, this requirement was removed for schemes that were at least 100% funded on the MFR basis at the last valuation. The annual administrative savings resulting from that change were £50 million. That was assumed to remove the requirement from five-sixths of schemes. Abolishing the requirement for the remaining schemes would produce further administrative savings of around £10 million gross, or around £5 million net of corporation tax.

*Introduction of the Statement of Funding Principles*

40. To some extent the information to be included in the Statement of Funding Principles (SFP) will already be available. For example, the professional guidance issued to scheme actuaries requires them to include in actuarial valuation reports an outline of the scheme's funding objectives and the method being employed to meet those objectives, and a statement indicating what

[8] Source: GAD Survey of Occupational Pensions (2000)

actuarial assumptions have been used in the valuation. The requirement to prepare a formal stand-alone document will, however, inevitably lead to some additional administrative costs. Estimates based on the experience of producing current Statements of Investment Principles indicate that these additional costs might be in the region of £2,500 per statement. For the 40,000 defined benefit schemes currently subject to the MFR, this would represent total one-off administrative costs of around £100 million, or around £70 million net of corporation tax.

41. On the assumptions that the SFP will be reviewed every three years (in line with the cycle of actuarial valuations), with additional reviews on an exception basis, and that such reviews will cost about 50 per cent of the cost of the initial SFP, the additional annual ongoing costs for reviewing SFPs is estimated to be around £15 million or around £10 million net of corporation tax.

***Communication with scheme members***

42. In addition to preparing a Statement of Funding Principles, it is also proposed that trustees should be required to provide key information about the funding position of their scheme. This information would be updated regularly, perhaps annually.

43. Pension schemes are already required to disclose some information on request (such as annual reports, actuarial valuations, and details of contribution schedules). In addition some schemes already send regular information to members, such as annual benefit statements showing their accrued entitlements in the scheme. A requirement for all scheme to issue key information about funding to all members will inevitably lead to some additional administrative costs. These are estimated to be around £25 million a year or around £15 million net of corporation tax if statements. This assumes that 80 per cent of members already receive annual communications from their schemes. It is assumed that on average it will cost £10 per member to prepare and send such information to the other 20% of scheme members. The estimate has been rounded up to make some allowance for the small extra cost of preparing the precise information needed for those schemes which already send annual communications to members.

44. It should be noted however, that we are floating an option to rationalise the legislation governing the way schemes communicate with their members and others, for example, by replacing many of the current detailed time limits for providing information with a more “ within a reasonable time approach”, and ensuring that schemes will only be required to send key pieces of information to their members. We anticipate that overall our proposals on communicating with scheme members, outlined in section E, should result in administrative savings.

**Summary of costs and benefits**

45. In summary, the proposals for replacing the MFR will lead to estimated one-off administration costs for pension schemes of around £70 million, and

estimated administrative savings of around £10 million a year on an ongoing basis (as shown in the table).

Summary of estimated ongoing administrative savings (net of corporation tax)

| Costs | £million | Benefits | £million |
|---|---|---|---|
| Maintaining Statement of Funding Principles | 10 | Removal of MFR valuations | 30 |
| Annual Funding Statements | 15 | Removal of annual recertifications | 5 |
| Total | 25 | Total | 35 |

46. It is estimated that there might be further savings of around £70 million a year arising from the impact of the removal of the MFR on schemes' investment strategies. In addition it is estimated that there will be a cash flow effect for underfunded schemes, as outlined above.

**Consultation**

47. The decision to replace the MFR with scheme-specific funding requirements followed a widespread consultation on the future of the MFR launched in September 2000, and the proposals set out in this Paper take account of comments received during that consultation. The Government has subsequently published three further papers as part of an ongoing process of consultation, which included setting up a Consultation Panel with representatives from the pensions industry, consumer organisations, employers and trades unions. This Panel has assisted in developing the details of the proposals to replace the MFR.

**Summary and Recommendation**

48. The Government believes that the proposed framework for scheme funding strikes an appropriate balance between the objectives of flexibility and affordability for employers, and protection for scheme members.

**B. CHANGES TO CONTRACTING OUT**

49. This covers options on:

i) Survivors' Benefits;
ii) Limited Price Indexation;
iii) The Reference Scheme Test (RST);
iv) Simplification of Guaranteed Minimum Pensions (GMPs); and
v) Restrictions on how and when benefits can be taken.

**(i) Survivors' Benefits and (ii) Limited Price Indexation**

**Description**

50. The options covered in this paper are:

- making the provision of survivors' benefits voluntary for contracted-out schemes;

- making the provision of indexation of pensions in payment voluntary – a proposal that applies more widely but is particularly pertinent to contracting-out;

- introducing an indexation threshold where the requirement to provide mandatory indexation is removed for pensions above this limit; and

- other options on indexation include reducing the rate of Limited Price Indexation (LPI) to 3 per cent or amending LPI so that indexation required on pensions in payment would be RPI minus 1 per cent or 5 per cent, whichever is the lesser.

**Risk Assessment**

51. It is for employers and employees to decide whether defined benefit or defined contribution schemes suit them best, but if the compulsory provision of indexation and survivors' benefits is driving those decisions, there is a case for looking at the issue again.

52. As well as funding pressures, compulsory indexation brings an administrative cost where schemes have to keep a record of different parts of the pension, which may have to be indexed in different ways. Again, there is a risk that the regulatory framework can drive decisions about what kind of pension to provide (defined benefit or defined contribution) when those decisions should be made on the basis of what best suits the employer and employee.

53. However it should be noted that both these options carry the risk of reducing the pension payable to members. This is discussed below.

54. One way of reducing the potential impact of the removal of the requirement to provide indexation would be to introduce an indexation threshold. Such an indexation threshold would mean that the requirement to provide indexation would only apply to pensions below the threshold. Those with small to medium pensions (however defined) would be guaranteed indexation whilst those with large pensions (again subject to definition) would not be guaranteed indexation. This might help to reduce the funding cost pressures on schemes but it would add to the complexity of the system and could add to administrative burdens.

55. Other options for simplifying indexation (including reducing the level of LPI to three per cent, or amending the indexation requirement to LPI or RPI minus one per cent, whichever is the lesser) would also reduce the funding pressure on sponsoring employers. However these options would apply to future

accruals only and would add to the administrative costs for sponsoring employers and schemes as another layer of complexity is added to the existing requirements. For scheme members, reducing the LPI requirements could result in the real value of their eventual pension in payment declining over time, if employers opted to pay no or lower increases in the future.

**Identification of Options Rejected**

56. We considered extending LPI to pensions derived from non contracted-out rights in personal pensions and stakeholder pensions, to create a more level playing field between defined benefit and defined contribution schemes. At present, in defined contribution schemes (but not defined benefit) people can opt for a higher starting pension and no indexation, or a lower starting pension but with indexation. We rejected this option as the Inland Revenue estimates that where they have a choice, around 80 per cent of people opt for a higher headline pension that does not provide for either indexation or survivors' benefits. Removing this option would therefore reduce individual choice.

**Issues of Equity or Fairness**

57. We need to decide whether the potential benefit reductions for scheme members is likely to be more than offset by overall benefit provision being higher than would otherwise be the case. Depending on the behavioural response of employers, it is possible to envisage wider pension coverage but with lower benefits in some cases. Alternatively, it could be possible for benefits to be reduced with no or little increase in coverage – benefiting employers at the expense of employees. We would need more evidence as to the likely response of employers to these proposals, and their likely actions if there were no change, before we could determine their merit.

58. These measures should not have a disproportionate effect on small and medium sized employers. The majority of firms providing defined benefit provision are small and medium sized. However, it should be noted that a majority of members of defined benefit pension schemes are in larger schemes. From this, it seems reasonable to infer that a majority of members of defined benefit schemes work in larger firms. In this sense, the proposals do not have a disproportionate effect on small or medium sized employers.

**Costs including Savings and Benefits**

*Defined benefit schemes: benefits and savings*

59. Removal of indexation and survivors' benefits requirements would reduce the financial pressures, on defined benefit schemes that choose to remove these benefits, assuming that they did not replace them with other equivalent benefits (such as a higher accrual rate). Those firms offering defined benefit schemes who take advantage of the flexibility provided by the removal of compulsion could make savings by reducing the rate of their contributions to the pension scheme. We estimate that the removal of compulsory indexation could save firms roughly 20 per cent on their future contributions to pension

schemes and the removal of compulsory survivors' benefits roughly 20 per cent, in the same areas, as well[9].

*Defined benefit schemes: costs to individuals*

60. However these savings for firms will mean losses to individuals. A recipient of a non-indexed pension will see his or her pension lose its real value over time. For an average man his final pension payment may be 30 per cent less than it may otherwise would have been; for an average woman the loss is around 40 per cent[10]. With regard to the proposal to remove survivors' benefits it is not possible to make such a comparison for illustrative individuals as we are considering the removal of a whole benefit, not a loss in value. However, the loss in pension income over a whole, combined retirement for an average couple would be around 20 per cent. Most of the individual losers would be women, as they form, and are expected to form, the majority of survivors' beneficiaries[11].

*Defined contribution schemes: potential benefits to individuals*

61. In contracted-out defined contribution arrangements removing the requirement to provide compulsory indexation and survivors' benefits from that part of the pension derived from protected rights, would provide greater choice for the individual scheme member and increase the starting level of the pension, but it would diminish in real value each year (because there would be no indexation) and there would be no survivors' benefit.

**Summary and Recommendations**

62. The measures in this paper include:

- making the provision of survivors' benefits voluntary for contracted-out schemes;
- making the provision of indexation of pensions in payment voluntary – a proposal that applies to all pensions but is particularly pertinent to contracting out;
- introducing an indexation threshold where the requirement to provide mandatory indexation is removed for pensions above this limit; and
- other options on indexation include reducing the rate of Limited Price Indexation (LPI) to 3 per cent or amending LPI so that indexation required on pensions in payment would be RPI minus 1 per cent or 5 per cent, whichever is the lesser.

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[9] These savings are independent, but cannot be added together to gain an understanding of the combined effect of introducing these policies simultaneously.
[10] Note, survivors also lose from non-indexation as their pension would also have lost value.
[11] These individual losses, described in the last two paragraphs, are 'steady-state', ie apply to individuals who have spent their entire working life under the new system. Individual losses for those retiring before 2050 will be proportionately less.

63. We would not introduce these changes unless we had good reason to believe that the coverage of, and contributions to, occupational pensions would be higher than would otherwise be the case.

64. ***We welcome comments on the above issues. In particular, we would welcome any evidence as to the likely behavioural response of employers to these measures if they were to be introduced***:

(i) would employers actually remove indexation if they could?
(ii) would employers actually remove survivors' benefits if they could?
(iii) would employers replace these benefits with others of equal value?
(iv) what effect (if any) would these measures have in terms of driving employers to provide defined benefit or defined contribution pensions?

**(iii), (iv), (v) The Reference Scheme Test, Simplification of Guaranteed Minimum Pensions and Restrictions on how and when benefits can be taken**

**Description**

65. The key areas for consideration are as follows:

- reform the Reference Scheme Test (RST) which salary related schemes are currently required to meet in order to contract-out;
- working with pensions industry and scheme professionals to address problems with Guaranteed Minimum Pensions (GMPs); and
- removing the restrictions on normal pension age and lump sums.

66. The objective of these measures would be to make contracted-out occupational schemes easier to administer through reducing the level of complexity currently involved in providing them and to provide greater flexibility for schemes.

**Risk Assessment**

67. Taken together, the RST, GMPs and restrictions on normal pension age and lump sums contribute to the inflexible nature of the regulation of defined benefit occupational pension schemes. If companies want to switch from defined benefit to defined contribution arrangements, they are entitled to do so (although it is important that they continue to make adequate contributions) but any such switching should be driven by the interests of the employer and employees, not by the nature of the regulatory system; there is a risk that the complexity of the contracting out rules, particularly as they affect defined benefit schemes, may have that effect.

**Identification of Options Rejected**

68. Consideration was given to introducing the reformed RST in addition to current arrangements. Under this option, schemes would be able to choose which RST would overall serve their member's interests best and, where opting for the reformed test, could convert benefits on an actuarial equivalence basis. The transition could be undertaken without member consent and would be on a scheme-wide basis. This option was rejected, as it added another layer of legislative complexity, which may act to discourage employers from providing contracted-out defined benefit pension schemes. Conversion on a scheme-wide basis also created the potential for some members to be worse off, regardless of which RST the scheme chose to comply with.

**Issues of Equity and Fairness**

69. As with all the proposals, it is necessary to strike the right balance between flexibility and cost control for employers with protection and reasonable benefits for members. Abolition of GMPs and removing the restrictions on normal pension age and lump sums would be significant simplifications that should not disadvantage the majority of members. Changes to the RST could result in reduced benefits for members if employers took advantage of the opportunity this offered (currently, the great majority of employers provide benefits in excess of the requirements of the existing RST).

70. These measures should not have a disproportionate effect on small and medium sized employers. The majority of firms providing defined benefit provision are small and medium sized. However, it should be noted that a majority of members of defined benefit pension schemes are in larger schemes. From this, it seems reasonable to infer that a majority of members of defined benefit schemes work in larger firms. In this sense, the proposals do not have a disproportionate effect on small or medium sized employers.

**Costs including Savings and Benefits**

***Administrative costs and savings***

71. These measures are likely to involve some initial administrative costs, but with longer term savings. However in the longer term we believe that bringing contracted-out benefits more closely in line with other scheme benefits should reduce administrative costs. We have not been able to estimate the administrative saving which might accrue from these changes to contracting-out on their own. However, we estimate that if combined with a move to a one stage internal disputes resolution, easier transfers, and less prescription in relation to disclosure of information, the overall administrative savings could be around £40-80 million a year. ***We would welcome the views of all businesses on these estimates.***

***Funding savings***

72. Most schemes provide benefits in excess of the existing RST and there is no evidence that this would not continue to be the case if the new RST were to be introduced. Without an understanding of the number of schemes which would

reduce their pension benefits as a result of the new test, we cannot estimate the savings that would result.

73. In addition, we do not know whether, or the extent to which, this change might effect employers behaviour in relation to choosing to provide defined benefit as opposed to defined contribution pension schemes.

74. ***We would welcome views on these issues***:

(i) whether your company or clients would be likely to reduce benefits if the new RST were introduced; and

(ii) whether these changes would be likely to affect your company's/clients' decisions about whether to provide defined benefit as opposed to defined contribution schemes.

**Summary and Recommendations**

75. The three main changes which could be introduced to simplify contracting-out are:

- reform the Reference Scheme Test (RST) which salary related schemes are currently required to meet in order to contract-out;
- working with the pensions industry and scheme professionals to address problems with Guaranteed Minimum Pensions (GMPs); and
- removing the restrictions on normal pension age and lump sums.

76. ***We would welcome views on these options, especially from small and medium sized businesses.***

## C . GREATER FLEXIBILITY FOR SCHEMES

77. This includes options on:

(i) Simplifying the arrangements under which schemes are restricted from modifying accrued rights;

(ii) Member-Nominated Trustees (less prescription on the selection processes and abolition of the employers opt out); and

(iii) Internal Dispute Resolution.

### (i) Simplifying the arrangements under which schemes are restricted from modifying accrued rights

**Description**

78. Section 67 of the Pensions Act 1995 prevents changes being made to the rules of a scheme that would reduce a member's accrued pension rights without the member's consent. In effect it preserves not just the value of the member's rights, but the rights themselves.

79. The proposal would enable defined benefit occupational pension schemes to make limited modifications to members' accrued pension rights, without member consent. Such changes would be permitted where the actuarial value of the change does not exceed a certain percentage limit of member's total accrued rights (five per cent has been suggested) and the rights being changed are replaced by something of equivalent actuarial value.

**Risk Assessment**

80. Doing nothing prevents schemes from making any detrimental changes to a member's accrued pension rights, even if those rights are replaced by something else, without first obtaining the member's consent. For example, it prevents an employer who, perhaps following a company take-over, is sponsoring two pension schemes and who wishes to change some of the rules of one scheme to mirror those of the other, thereby simplifying the administration of the schemes and reducing costs.

**Identification of Options**

81. Two alternative options were considered. (i) Do nothing. (ii) Permit schemes to modify members' accrued rights in any way, providing they are replaced by something of equivalent actuarial value.

82. Both were rejected. The current provisions in section 67 are too restrictive and prevent any amendments to rights already accrued. We felt that the alternative (the Pickering Report option) would be too permissive because it would allow employers to fundamentally change the terms of the pension scheme, in effect to overturn the pension promise.

**Issues of Equity and Fairness**

83. Our objective is to allow schemes the flexibility to make changes where that could save on administration, but not at the expense of members' benefits. The proposal discussed here would meet that equity and fairness test.

84. In terms of the impacts on business, the costs and benefits would apply to both small and large schemes/businesses. However, the provisions are more likely to be used by larger self-administered defined benefit schemes, who see the opportunity to reduce their costs over time. Set against the total administrative costs of these larger schemes, the amounts involved are likely to be small. There may be some additional costs for the regulator where, for example, a member asks the regulator to look into the circumstances where a scheme has used its power to make modifications that change accrued rights. Schemes

may also ask the regulator for guidance when considering proposals for change. We do not envisage much additional work for the regulator.

**Costs including Savings and Benefits**

85. The proposal does not place any requirement or obligation on schemes. Schemes would be free to make use of the amended section 67 if they wanted. We do not have an estimate of the administrative savings this change is likely to produce. ***We would welcome views from those running pension schemes as to how much of a saving might result***.

**Summary and Recommendations**

86. The proposal is to amend section 67 so as to allow employers to make limited changes to schemes where that is to their advantage administratively, but whilst safeguarding members' benefits. ***We would welcome the views of businesses, on the administrative savings they believe this measure could generate***.

**(ii) Member-nominated trustees – less prescription on the selection process and abolition of the employers opt out**

**Description**

87. At present, there is a legislative requirement for schemes to have one-third of their trustees nominated by the membership, although employers have an opt-out option.

88. The proposal is to change the Member-nominated trustees (MNT) requirements to ensure that every scheme has at least one-third MNTs, and radically simplify the legislation. The current complex and prescriptive legislation would be replaced by minimal requirements in legislation, backed by guidance issued by the Regulator.

**Risk Assessment**

89. The risks of doing nothing are:

- that some schemes would continue to avoid having MNTs; and
- the legislative prescription regarding the selection processes would continue to be onerous for employers and potential cost savings are not realised.

**Identification of Options**

90. We considered commencing the legislation already enacted in the Child Support, Pensions and Social Security Act 2000, but decided against this on the grounds that it did not offer the sort of simplification and flexibility that we are seeking.

**Equity and Fairness**

91. We believe that it is right that all schemes should have one-third MNTs. However, we also think that the level of prescription on employers who voluntarily provide defined benefit schemes should be kept to a minimum, consistent with adequate member protection. We think this proposal meets that test.

92. ***We would welcome views. We would particularly welcome the views of small and medium sized businesses as to the likely impact these proposals may have on them*.**

**Costs including Savings and Benefits**

93. The costs of, and savings generated through, amending the MNT provisions are difficult to assess with any degree of accuracy because they have an impact on different schemes in different ways depending on:

- the size of the scheme;
- the route taken by the scheme to meet current statutory requirements; and
- details of the arrangements adopted by the scheme to meet the new requirements.

94. There would be start up costs. These would fall mainly on schemes that do not currently have MNTs and is likely to be spread across a small number of large schemes, and a large number of small schemes. Overall, the one off administrative costs of this proposal could be in the region of £35 million, across all schemes. There will be significant ongoing savings for all schemes through not having to undertake a statutory consultation procedure, and through having more flexibility to adopt arrangements that suit their own circumstances. This could be in the region of £20 million per annum, across all schemes. The savings will be greater for large schemes because they have more members to contact.

**Summary and Recommendation**

95. The proposal is to remove the employer opt-out on MNTs but also to remove the prescription in terms of the selection procedure.

96. We would welcome the views of businesses on our estimates of the costs of implementing these proposals and also on the overall level of administrative savings that we believe could be generated from this measure. We would particularly welcome the views of small and medium firms.

(iii) Internal Dispute Resolution

**Description**

97. Currently, the procedure for dealing with internal disputes is in two stages. It must include provision for the original decision to be reconsidered by the trustees or managers if the complainant is unhappy with the decision reached in the first stage. Regulations set out details of how the process should work including details of how the complaint should be raised and time limits in which responses must be given. Trustees or managers can be fined by Opra if the arrangements are not set up or followed.

98. The proposal is that the statutory internal dispute resolution procedures should be made simpler by removing the requirement for a two-stage process.

**Risk assessment**

99. The current rules are rigid and very prescriptive. They are often said to be unhelpful for members who have to refer their complaint to the scheme a second time before they can take their case to the Pensions Ombudsman, and result in the parties getting into entrenched positions through which it is more difficult to mediate. Precise figures on the frequency with which statutory internal dispute resolution procedures are invoked are not available, but each year around 3,000 enquiries are received by the Pensions Ombudsman. Many cases will have been resolved one way or another before reaching the Ombudsman.

**Issues of Equity and Fairness**

100. It is essential that scheme members have access to a dispute procedure. That will not change. But it is also important to ensure that the procedure is as efficient, as well as effective, as possible. That is what this proposal aims to achieve.

101. ***We would welcome the views of small and medium sized businesses on the impact these proposals may have on them***

**Costs including Savings and Benefits**

102. Current arrangements will need to be adapted where trustees want to use the simplified arrangements which could lead to one-off costs for administrative system changes. Schemes will be able to retain a two-stage process if they wish. But the simplified arrangements should reduce costs in the longer term in terms of staff time, by cutting out the need for an internal review where the matter has not been resolved at the first stage. Savings in any particular scheme will depend on the extent to which there is a call on its dispute resolution procedures and the level of disputes that cannot be resolved at the initial stage.

103. We do not have an estimate of the overall saving to business that this proposal might have. However, we estimate that if combined with a move to the contracting out proposals already described, easier transfers, and less prescription in relation to disclosure of information, the overall administrative

savings could be around £40-80 million a year. We would welcome the views of all businesses on these estimates.

**Summary and Recommendation**

104. The proposal is to move from a two-stage internal dispute resolution procedure to a one-stage procedure. ***We would welcome views on the impact of this proposal on the administrative costs of a typical scheme, and also on small and medium sized employers.***

## D. PRESERVATION AND TRANSFERS

**Description**

105. The preservation requirements are necessary to ensure that people who change their jobs still get a pension from their previous employer's pension scheme. If they want to move their accrued rights to the new employer's scheme or to a personal pension or stakeholder pension, they can request a transfer value. These are well established measures to remove disincentives to job mobility.

106. One of the ways in which we could make the requirements relating to transfers values less prescriptive would be to change the way in which cash equivalent transfer values (CETVs) are calculated. In line with the introduction of scheme-specific funding arrangements (the replacement for the minimum funding requirement described earlier) we propose that trustees would decide the way in which CETVs should be calculated on the advice of the scheme actuary without reference to a statutory underpin.

107. In addition to this specific option, we want to ask interested parties for views on how the system could be simplified, whilst retaining the principle that apension should be either preserved or transferred when a person leaves pensionable employment.

**Risk Assessment**

108. Current rules are very detailed and complex, spread over different Acts and several sets of regulations. They cause a lot of administrative complexity and operational difficulties. The statutory underpin to the calculation of cash equivalent transfer values produces amounts that could be lower or higher than scheme-specific calculations, depending on the assumptions adopted by each individual scheme.

**Issues of Equity or Fairness**

109. Removing the statutory underpin from the calculation of CETVs would mean that amounts could vary quite widely from scheme to scheme. Thus two people with the same career history in different schemes with a similar benefit structure could be offered very different amounts if they each requested a transfer value, depending on the actuarial assumptions used by each scheme.

That is a consequence of using a scheme-specific approach. But each would be treated equally compared with other members of their own scheme.

110. ***In terms of the impact on business, we would particularly welcome the views of small and medium sized businnesses.***

**Costs including Savings and Benefits**

111. We do not have an estimate of the overall saving to business that changes to the calculation of CETVS might have. However, we estimate that if combined with a move to the contracting out proposals already described, less prescription in relation to disclosure of information, and a move to a one-stage internal disputes resolution procedure, the overall administrative savings could be around £40-80 million a year. ***We would welcome the views of all businesses on these estimates***.

**Summary and Recommendation**

112. The proposal is to simplify the way in which CETVs are calculated and to seek other ways of simplifying the transfer process. ***We would welcome the views of businesses on the potential reduction in administrative costs that this measure could produce and views on what other simplification options could reduce costs.***

## E. COMMUNICATION WITH SCHEME MEMBERS

**Description**

113. The proposal is to rationalise the legislation governing the way schemes communicate with their members and others, replacing many of the current detailed time limits for providing information with a "within a reasonable time" approach, and removing prescriptive detail where possible. Schemes would only be required to send key pieces of information to their members automatically.

**Risk Assessment**

114. Doing nothing puts at risk our aim of ensuring that individuals can exercise informed choice in relation to pensions. Poorly targeted information risks scheme members failing to identify and act on the important messages contained in this information.

**Equity and Fairness**

115. The objective of this option is to ensure individuals get the right pension information.

116. The benefits would apply to both small and large schemes. ***We would particularly welcome the views of small and medium sized businesses on the effect they believe this proposal will have on them.***

**Costs including Savings and Benefits**

117. There are no direct additional administrative costs associated with this option. The amount of information automatically provided to scheme members would be no greater than is currently required, and there is likely to be a reduction. Schemes might benefit from some small administrative savings but the major benefit is a less prescriptive approach and hence a little more flexibility. Schemes would still be required to send information to members, but the amount of information may reduce, thereby providing schemes with small savings.

118. There may also be some marginal additional costs for the regulator, which would set out and, from time to time, review the guidelines which define a "reasonable time", and which would intervene in cases of dispute. We do not, however, anticipate that this would be an area that would require significant regulatory involvement.

## F. PENSIONS ON DIVORCE

**Description**

119. Options for simplification in the following areas are being considered:

- consolidating the pension sharing secondary legislation for England and Wales in one Statutory Instrument;
- repealing the superfluous divorce proceedings requirements contained in Part II of the Family Law Act 1996;
- considering the rationalisation of destinations for pension credit e.g. safe harbour products;
- removal of a (default) option regarding transfers of pension shares out of the originating scheme;
- revision of the pension credit ill health and serious illness provisions to be consistent with the derivation of a pension share;
- removal of 'safeguarded rights' requirements. This would result in the repeal of one set of regulations and several sections of primary legislation;
- rebuilding limits and therefore some tax rules may be removed as a result of the tax simplification review; and

- the alignment of "normal benefit age" for payment of pension credit benefit in occupational and personal pension schemes is being considered.

**Risk Assessment**

120. We are not aware that the pension sharing arrangements are causing problems, but we acknowledge that there is scope for some legislative and/or procedural simplification. We would welcome views on whether, and to what extent, the pension sharing options place the objectives of simplicity and protection for members at risk.

**Identification of Options**

121. ***We would welcome views on whether and to what extent the legislation and/or the practices could be simplified.***

**Issues of Equity and Fairness**

122. Any proposals will need to be fair to both men and women.

**Costs including Savings and Benefits**

123. None identified yet. ***We would ask those putting forward proposals to give an indication, where possible, of their assessment of the likely cost implications***.

**Summary and Recommendations**

124. We have identified a number of simplification options, described above. ***But we would welcome views.***

# PROTECTING EMPLOYEES

## G. PROTECTION IN THE CASE OF WIND-UP

125. This includes options on:

- fairer sharing of assets
- amending the priority order of creditors
- insolvent employers
- improved compensation arrangements
- solvent employers
- speeding up winding up

**Background**

126. Where pension schemes are wound up, members can be at risk of losing their pension rights or having them reduced. This can occur in the case of solvent

employers (the current funding rules do not provide full protection to all members) and also in the case of insolvent employers (who may have insufficient funds to top up the fund).

127. We have limited information about the effects on individuals whose scheme winds up (some will be in schemes which are fully funded, others will be in schemes which are under-funded) but a number of recent cases have highlighted the need to strengthen member protection in this area.

**Terms used**

128. **'Winding up'** is the process of terminating an occupational pension scheme, usually by applying the assets to the purchase of immediate annuities and deferred annuities for the beneficiaries, or by transferring the assets and liabilities to another pension scheme, in accordance with scheme documentation or statute.

**(i) Fairer sharing of assets**

*Rebalancing the priorities between pensioners and non-pensioners*

**Description**

129. This technical paper seeks views on changes to the statutory priority order under which pension schemes assets are distributed when a scheme winds up. The objective of the options described below is to ensure that when a scheme winds up, the assets are divided among scheme members as fairly as possible. Amending the priority order might result in a fairer distribution of assets.

130. There are a number of possible reforms:

Option 1: Under this option a new category would be included to protect the benefits of individuals nearing retirement.

Option 2: Under this option a new category would be included to protect people based on the number of years they have contributed to their scheme irrespective of age.

Option 3: Under this option, the pensions of people who had taken early retirement within, say, the 12 months preceding the start of the wind-up of their scheme would be capped at a certain level, for example, £30,000 a year.

Option 4: Under this option, the pensions of all pensioners would be capped at, say, £30,000 whenever they had retired.

**Risk Assessment**

131. If we do nothing, non-pensioner members would continue to be at risk of losing significant amounts of pension rights when a scheme winds up. The

extent of this risk would also depend on whether proposals on the debt on the employer and/or a form of insurance were implemented (these are discussed below).

**Equity and fairness**

132. The options described would have the advantage of sharing out assets in ways that would give more protection to some non-pensioners. However, any changes to the priority order have the disadvantage of reducing protection for some scheme members.

**Costs including Savings and Benefits**

133. If Option 1 was implemented, the benefits to people nearing retirement age would be at the cost of younger members who would be lower down the priority order. If Option 2 was implemented the benefits to those who had been in the scheme longer would be at the expense of those who had been in the scheme for less years. With Options 3 and 4, the £30,000 cap on pensions would reduce the pensions in payment of those people affected by the change to the benefit of those who had not yet retired.

**Summary and Recommendations**

134. These proposals give greater additional protection to some non-pensioners in the case of wind-up. We do not think there would be additional administrative costs for schemes. ***We would welcome views on whether you agree with this.***

**(ii) Amending the priority order of creditors**

**Description**

135. This technical paper seeks views on making pension schemes a new category of creditor, between the floating charge creditors and unsecured creditors. This would give pension schemes a higher priority than unsecured creditors.

**Risk Assessment**

136. The risk of doing nothing is that scheme members are vulnerable to the risk of not receiving their pension entitlement if an under–funded scheme is wound up because of employer insolvency.

137. The risk of increasing the priority of pensions is that employers with defined benefit schemes could find it harder to obtain trade, credit and unsecured loans; or the cost of those loans could increase. Furthermore, other unsecured creditors would lose out, which might mean some, such as trade creditors, have to downsize or go into insolvency themselves.

**Issues of Equity and Fairness**

138. If the change were implemented, it would only apply if an employer were to become insolvent. Where that happened, any gain for pension scheme members would be at the expense of other creditors.

**Costs including Savings and Benefits**

139. If the change were implemented, members of defined benefit pension schemes that were wound up as a consequence of employer insolvency could benefit from the pension debt being met ahead of the debts of other creditors. It is not possible to quantify the extent of the benefit because it would depend on a wide range of factors, such as the extent of the under-funding, how much the company owed and to whom etc. Increasing the priority of pensions in the event of insolvency may make it harder for employers with defined benefit schemes to obtain trade, credit and unsecured loans; or the cost of those loans could increase

**Summary & Recommendation**

140. The proposal is to give greater protection in the case of wind-up. We do not think there would be additional administrative costs for schemes. ***We would welcome views on the effects of this.***

**(iii) Insolvent employers**

**Description**

141. This technical paper seeks views generally on the idea of a form of insurance of a centralised 'clearing house' arrangement for schemes that are under-funded when the employer becomes insolvent. This would provide better protection for scheme members if a scheme was wound-up underfunded as a consequence of employer insolvency:

- a form of centralised clearing house into which scheme members whose employer became insolvent and whose scheme is winding-up could choose to pay the funds that they receive on wind-up. The clearing house might be able to negotiate better annuity rates than trustees of individual schemes could negotiate.

- an insurance arrangement, such as a Central Discontinuance Fund (CDF), which would protect scheme members whose employer became insolvent. This would provide scheme members with a guarantee of a certain level of benefits. Different models would offer differing degrees of benefit replacement and guarantee.

**Costs including Savings and Benefits**

142. The centralised clearing house is likely to involve some minimal administrative costs to set up and run. However, trustees' negotiating position would be strengthened by their coming together in a single fund and this would benefit scheme members. The insurance arrangement could be funded

by, for example, a reduction in pension benefits or increased contribution rates. The costs would need to be balanced against the greater overall level of security offered.

**Summary and Recommendations**

143. These proposals are designed to provide better protection for scheme members. ***We would welcome views on these options and their potential impact.***

**(iv) Improved compensation arrangements**

**Description**

144. A Compensation Scheme was established by the 1995 Pensions Act to compensate schemes, where the employer is insolvent, for loss caused by dishonesty. It is financed by a levy paid by occupational pension schemes.

145. There are currently restrictions on the amount of compensation which can be paid in cases of dishonesty. For defined benefit schemes, legislation restricts the amount of compensation which can be paid to the amount needed to bring the value of the scheme's assets up to 100 per cent of its liabilities for pensioners and members within ten years of retirement, and 90 per cent of its liabilities for other members (calculated using the valuation methodology for the minimum funding requirement) or, if lower, the amount of the actual loss. For defined contribution schemes, compensation is limited to 90 per cent of the loss.

146. It is proposed to enhance the current arrangements to remove these restrictions, and provide that schemes with an insolvent employer can be compensated for the full amount lost as a result of acts of dishonesty.

**Risk Assessment**

147. If the proposed change were not implemented, the security of the pension rights built up by members of schemes which suffer from acts of dishonesty would continue to be at risk.

**Identification of Options**

148. For defined benefit schemes, the method of calculating the amount of compensation payable is currently linked to the minimum funding requirement (MFR). Since the Government proposes to replace the MFR with scheme-specific funding requirements, continuing with the current arrangements is not an option. The proposal to allow compensation to cover the full amount lost would be simple to operate and transparent, and the Government believes this is the appropriate way to proceed.

149. The Government considered limiting the compensation payable in the case of a defined benefit scheme to the amount needed to restore it to full funding on

the basis of the scheme-specific approach it adopted after the MFR is replaced. This was ruled out because it could give rise to inconsistencies in the amounts of compensation payable. The Government also considered enabling the Pensions Compensation Board to have discretion to pay a lower amount of compensation than the actual loss, but this would increase complexity, and could lead to allegations of unfairness.

**Issues of Equity or Fairness**

150. The proposals do not give rise to issues of equity or fairness.

**Costs including Savings and Benefits**

151. Broad estimates indicate that the increase in the total amount which would need to be raised by the levy across all schemes, might be of the order of £10,000 a year. However the estimate must be regarded with caution, since it is based on the small number of cases which have come to light in the short time the Scheme has been in operation (compensation has been paid in only three cases). There is no other available information on which to base an estimate, but the figure would clearly be substantially increased in the event of a large fraud. We would welcome the views of the cost of these proposals on businesses, in particular small and medium sized ones.

**Consultation**

152. In March 2001, the Government published "Security for Occupational Pensions: The Government's Proposals", which set out the Government's proposals for replacing the MFR. It also included proposals for enhancing the Compensation Scheme.

**Summary and Recommendation**

153. The proposal to allow schemes where the sponsoring employer is insolvent to be compensated for the full amount lost as a result of acts of dishonesty would be simple to operate and transparent, and the Government believes that this is the right way to proceed.

**(v) Solvent employers**

**Description**

154. This technical paper seeks views on two options for changing the calculation of the liabilities of defined benefit pensions scheme that are winding up, carried out under the Deficiency on Winding Up Regulations; the “full buy-out” option and the “partial buy-out” option.

**Option 1: Full buy-out**

155. Under the full buy-out option the debt would be the amount needed to bring a scheme’s assets up to a level sufficient to meet:

- the actual costs of buying annuities and deferred annuities for all scheme members; and
- the trustees' estimate of all expenses likely to be incurred when winding up the scheme.

**Option 2: Partial buy-out**

156. Under the partial buy-out option, the debt would be the amount needed to bring a scheme's assets up to a level sufficient to meet:

- the actual costs of buying annuities with an insurance company for pensioners;
- the actual costs of buying deferred annuities for non-pensioners who are, say, within 10 years of pension age;
- cash equivalent transfer values (CETVs), on the proposed scheme-specific basis; and
- the trustees' estimate of all expenses likely to be incurred when winding up the scheme.

**Risk Assessment**

157. The risk of doing nothing is that when under-funded pension schemes are wound up by solvent employers, non-pensioner members will remain more likely, than pensioner members, to have pensions lower than they expect. This is because the debt calculation in respect of schemes that are wound up by a solvent employer is currently set at a level to bring a scheme's assets up to a level sufficient to meet:

- the actual costs of buying annuities with an insurance company for pensioners;
- cash equivalent transfer values (CETVs) on the MFR basis for people who have not retired; and
- the trustees' estimate of all expenses likely to be incurred when winding up the scheme.

158. Therefore non-pensioners are dependent on the investment returns on the CETVs they transfer into a defined contribution arrangement. Both options would increase the contingent liabilities of sponsoring employers and would risk making defined benefit provision less attractive. Increasing the cost of buy-out may lead some employers to scale back their pension provision.

159. The size of the problem will vary depending upon the state of the pension fund at the point of wind-up, the ratio of pensioners to non-pensioners in the scheme, and for individuals, the amount of pension accrued to date.

**Equity and fairness**

160. If either option were implemented they would have equal impact on all sizes of employers with defined benefit schemes. Those employers that chose to

wind-up would incur actual costs, and all employers would be faced with increased contingent liabilities. The objective of the options is to ensure scheme members receive better protection on wind-up.

**Benefits**

161. If either option were implemented, members of under-funded defined benefit pension schemes that were wound up by solvent employers would be likely to feel the benefits, through the increased likelihood of members getting the pension they had been promised.

**Costs**

162. If either option were implemented, only employers that wound up under-funded defined benefit schemes would bear the costs of the changes. But the potential costs, even if they do not actually arise, could be registered as a contingent liability, thus affecting employers' ability to borrow money and attract investors. The "full buy out" option could add costs (net of corporation tax) for employers around £1.25 billion a year and the "partial buy out " option could add costs (net of corporation tax) of around £200m a year. Because of the potential magnitude of the costs, these options would need to be considered very carefully. In our reforms we will be mindful of the overall burden of regulation on business.

163. The impact on individual employers would depend on a number of factors, including the level of funding, ratio of pensioners to non-pensioners etc. A description of the effect on an illustrative employer follows -

*Current situation*

The current debt on an illustrative employer whose scheme is 80% funded (on an MFR basis) and who chooses to wind-up the scheme is estimated to be (net of corporation tax):

- £2 million for a small scheme (350 members) with assets of £12 million
- £15 million for a medium scheme (2,200 members) with assets of £80 million

*Partial buy-out option*

The additional estimated costs (over and above the current situation) of the partial buy-out option on an illustrative employer whose scheme was 80% funded and who chooses to wind-up a scheme with 50 per cent pensioners and 50 per cent non-pensioners is estimated to be (allowing for corporation tax):

- +£1 million (above the current cost) for a small scheme (350 members) with assets of £12 million

- +£10 million for a medium scheme (2,200 members) with assets of £80 million

*Full buy-out*

The additional estimated costs of the full buy-out option falling on an illustrative employer whose scheme was 80% funded and who chose to wind-up a scheme with 50 per cent pensioners and 50 per cent non-pensioners is estimated to be (allowing for corporation tax):

- +£4 million for a small scheme (350 members) with assets of £12 million

- +£20 million for a medium scheme (2,200 members) with assets of £80 million

**Summary and Recommendations**

164. The proposal is to increase member protection in the case of a solvent employer winding up its scheme. ***We would welcome views on the impact of these options and on the estimated costs.***

**(v) Speeding up winding up**

**Description**

165. This technical paper seeks views on whether trustees should be allowed to discharge liabilities on wind-up to a stakeholder or money-purchase vehicle provided the member does not object and provided the person is over ten years away from normal retirement age.

**Risk Assessment**

166. The risk of doing nothing is that members wait for long periods of time before they receive their benefits. It is not uncommon for schemes to take 5 or 6 years to wind up.

**Equity and fairness**

167. If the proposals were implemented, they would apply equally to all employers and pension schemes but only when a pension scheme was winding up.

**Benefits**

168. If the proposal was implemented this would help to speed up the process of winding up.

**Costs**

169. If the proposals were implemented, the costs of winding up could be reduced because trustees could discharge their liabilities more quickly.

**Summary and Recommendations**

170. The proposal is to give greater protection to in the case of wind-up. We do not think there would be administrative costs for schemes.

## H. TRANSFER OF UNDERTAKINGS (PROTECTION OF EMPLOYMENT) REGULATIONS

**Description**

171. In their current form, the Transfer of Undertakings (Protection of Employment) Regulations 1981 exclude from their coverage continuing active membership of an occupational pension scheme. The issue is whether the Government should provide a degree of protection for occupational pension rights across purely private sector transfers. Protection is already provided as a matter of Government policy in transfers that involve the public sector.

172. The proposals are set out in detail in Part 2, Section H in the main technical paper.

**Risk Assessment**

173. At present, workers can lose employer pension contributions as a result of a transfer. The impact of any extension would be on the minority of cases where employers do not already provide a degree of continuity in occupational pension entitlement across a TUPE transfer as a matter of good practice. Even if such protection were to be provided, following a transfer, the employer would be at liberty to modify the provision should this become necessary for reasons unrelated to the transfer itself. Some argue that extension of TUPE to cover occupational pensions might mean some employers scaling back their pensions.

**Identification of Options**

174. The general issues and possible options for change set out in the this Green Paper consultation take account of responses to the DTI public consultation document issued in 2001 and are designed to be simple, flexible and worthwhile. They are not designed to provide either mirror image or broadly comparable protection of the kind that exists in the public sector.

**Issues of Equity and Fairness**

175. In terms of the impacts on business, the costs and benefits would apply to those employers who currently engage in business transfers without providing employees with a reasonable degree of occupational pension continuity. In the absence of accurate and comprehensive data on existing patterns of behaviour

it is difficult to identify accurately the impacts on behaviour of the options presented in this consultation or their likely duration.

**Potential Benefits and Costs**

176. Providing pension protection during private to private business transfers would provide additional protection to employees and impose additional costs on employers, although those employers who would in any event have met the requirements of any new regulation, would benefit from the creation of a level playing field.

**I. MEMBER-NOMINATED TRUSTEES – ABOLITION OF EMPLOYERS' OPT-OUT**

177. This proposal is covered in Section C.

## PROMOTION OF PENSIONS

**J. K. IMMEDIATE VESTING AND TRANSFER WITHOUT CONSENT**

**Description**

178. A person who leaves an occupational pension scheme within two years may not accrue any rights in the scheme but instead receive a refund of their contributions less tax. The period for which a person must be a member of a scheme for their rights to be retained in the scheme when they leave is known as a vesting period. Under the proposal a two-year vesting period would no longer be permitted and rights would vest from the time the member joined. Immediate vesting would benefit individuals who change jobs frequently by giving them the opportunity to save for a pension to which their employer also makes a contribution. On the other hand immediate vesting could result in schemes having to preserve a much larger number of small amounts of pension rights for many years, thus increasing the burden of administration. To avoid this schemes holding de minimis amounts of deferred rights should be able to transfer them to a stakeholder pension on the members' behalf, unless they object or request a transfer within six months of leaving employment.

179. The objective of these changes would be to ensure that the administrative burden of pension provision is not increased, whilst ensuring that individuals have the opportunity to build up a pension regardless of their duration of work with an employer.

**Risk Assessment**

180. Under the current rules a person who works for different employers for short spells, or for the same employer from time to time, may not accrue any rights to an occupational pension. Immediate vesting would enable that person to build up occupational pension rights and benefit from the employer's

contribution. However, administration of small amounts of pension can be costly, so it is necessary to consider the introduction of transfers to stakeholder products. This would make pension administration less costly for employers. Employees who have several small amounts of pension rights can consolidate them into a single fund.

**Identification of Options**

181. Options on these proposals are included in this technical paper.

**Issues of Equity or Fairness**

182. People who leave a firm before their pension has vested may lose out on a significant amount of pension. It has been suggested that this is unfair, particularly on younger workers who are more likely to change jobs frequently.

183. We recognise that the introduction of immediate vesting would increase the number of small amounts of pension rights in schemes. To avoid increasing administrative burdens we are also looking at introducing transfers of such rights to stakeholder pensions unless the member objects.

**Costs Including Savings and Benefits**

184. These proposals would improve the pension rights of workers who change jobs frequently. The overall impact on individuals would depend upon:

- the degree to which frequent job changers join company pension schemes in the first place;
- the different options given to early leavers by different pension schemes;
- the characteristics of those early leavers who take a contributions refund with them; and
- the degree to which any contributions refunds are currently re-invested in another pension scheme.

185. The transfer option would reduce the cost of preserving small amounts of pension.

186. Immediate vesting would increase costs if take-up by people in short term employment were to be high. It is difficult to estimate the effect of any potential increase in funding costs that this measure might result in. This will depend on a number of factors including current scheme rules in relation to vesting and waiting periods, the extent of any increase in membership by new employees, the age of people and the CETV basis used. There may also be increased administration costs. Average administration costs of maintaining rights in a pension scheme are estimated to be about £30 a year. Trustees would therefore have the option of arranging for transfers of small amounts of

pension rights out of the scheme to a stakeholder scheme on the member's behalf, unless they object.

187. Where trustees decide to arrange for transfers, this is likely to involve one-off start-up costs to make changes to their systems, as well as on-going costs associated with making these transfers. The net effect on administration costs and/or management charges is uncertain and is likely to vary from case to case. We would welcome views on the overall impact of these changes.

**Impact on the Individual**

188. The effect of this measure on different individuals would vary according to their sex, age, salary progression, type of pension scheme and, crucially, the basis used to calculate the cash equivalent transfer value. We have included below an illustrative case study.

> Miss Patel, aged 28, joins a company and becomes a member of the contracted-out defined benefit scheme which has a vesting period of 2 years. She earns £20,000 a year, and contributes 5 per cent of her earnings into the scheme.
>
> If she leaves the company after 1 year and 364 days, then at present she gets a cash refund of her contributions (after deduction of the employee share of the Contributions Equivalent Premium and net of tax ) of £1,200. A Contributions Equivalent Premium is paid to reinstate her State Second Pension rights for the period.
>
> However, if her rights had vested as soon as she joined the scheme, the total cash equivalent of her accrued rights after one year and 364 days is £3,400. She is therefore better off, with over £3,000 invested towards her pension.

**Summary and Recommendations**

189. We welcome comments on these issues, and whether people think the policy proposals should be carried forward. It is necessary to balance the rights of individuals to accrue pensions even if they are only with an employer for a short period of time against the additional administrative and financial burdens on employers operating schemes.

190. ***We would welcome the views of businesses of all sizes on whether they feel the adoption of immediate vesting and transfers would result in a net saving or cost for them. In particular we would welcome information about the number/proportion of employees who leave a business's scheme each year without having their rights vested or who may currently be deterred from joining because of a two year vesting rule. We would also welcome information on the current cost of calculating a transfer value and arranging a transfer, and the extent to which those costs are charged to individuals.***

## L. ALLOWING COMPULSORY SCHEME MEMBERSHIP

### Description

191. The proposal is to allow employers to make membership of their pension scheme a condition of employment. This would give them the opportunity to ensure that as many employees as possible participate in their scheme. Employers would not be forced to make scheme membership compulsory, and employees might be able to opt-out of schemes, perhaps if they were already making alternative pension provision.

### Risk Assessment

192. At any one time, about 25% of all employees with access to an employer's pension scheme do not join. Of these, only 15% are contributing to a personal pension. There is a risk that people with neither occupational nor personal pension provision will miss out on a significant employment benefit and end up with little or no private pension income in retirement.

193. A survey carried out by the National Association of Pension Funds (NAPF), indicates that 61 per cent of those surveyed answered definitely or probably yes, when asked if they would make membership a condition of employment if given the right[12].

### Issues of Equity and Fairness

194. Making compulsory membership a condition of employment would not be imposed on employers, so there is no additional burden on them. And by allowing individuals to opt out if they were making alternative pension provision, we avoid the risk of jeopardising their existing arrangements.

### Costs including Savings and Benefits

195. This proposal does not impose costs for employers because it would be voluntary.

### Summary and Recommendations

196. ***We welcome comments on these issues, and whether people think the policy proposals should be carried forward. We would welcome the views of businesses on whether they would consider implementing compulsory membership.***

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[12] These are the results of a telephone survey carried out by NAPF. The intention was not to provide a comprehensive picture of the industry, but to provide a snapshot from the point of view of scheme providers. One hundred NAPF members were interviewed – they include pension managers, administrators or other people responsible for some aspect of the scheme.