

Deregulatory Review of Private Pensions

**An independent report to the Department
for Work and Pensions**

Chris Lewin and Ed Sweeney

July 2007

Deregulatory Review – Foreword

To: Mike O'Brien, Minister for Pensions Reform

We were asked by your predecessor to carry out a deregulatory review of the legislation governing private pensions, and we now have pleasure in presenting our report. It deals with many of the issues we identified in the earlier stages of our work and which were covered in the Consultation Paper which we issued in March 2007. We much appreciate the numerous thoughtful responses we received, which we have read carefully and which have helped us to arrive at our recommendations. We were asked “to seek consensus” in our terms of reference. This has proved a difficult task: there is a very wide variety of views in the pensions industry, and whilst we have tried hard to reconcile inevitable differences in view in this very controversial territory, there remain a few areas where we have been unable to reach an agreed view. In those circumstances, we have tried to give a full account of our reasoning so that you can weigh the opposing views.

Although the report touches on certain matters which are the responsibility of the income tax authorities, we have regarded the laws on the tax approval of pensions schemes as being outside our terms of reference. We would note, however, that it is important that HMRC continue to build on the good work begun in the Finance Act 2004, and for DWP and HMRC to present a joined-up, better regulatory approach to pensions legislation.

Only twenty years ago the British system of occupational pensions was among the best in the world, providing generous pensions which were usually linked to members' final salaries and were often protected against rising prices after they commenced. Since then a number of factors - increasing longevity, collapses in equity markets, and heavy regulatory burdens among them - have caused a massive upheaval and today the pensions scene looks very different. Occupational pension coverage has declined from 34 per cent of the private sector employed workforce in 1987 to 19 per cent in 2006. Even where employees do still belong to occupational schemes, many of them nowadays belong to schemes where the contributions may not be high enough to provide an adequate pension.

In recent years, because many companies have no longer been prepared to bear the open-ended risks inherent in their defined benefit (DB) schemes, they have often closed those schemes to new members and may also have stopped the future accrual of benefits under those schemes for existing staff. In some cases, such employers have substituted new DB schemes which have lower costs or risks for the employer, and in other cases they have offered defined contribution (DC) schemes instead, or even no scheme at all other than a stakeholder plan. While DC schemes are not necessarily in themselves inferior, where employees belong to such schemes, they will have to bear many risks themselves, including, for example, the risk of poor investment returns and the fluctuating cost of annuities. These risks mean that, even where contributions are being made at a level that might be expected to provide an adequate pension, there may well be generations that end up with less than expected. But, in many cases, the level of contributions being paid is much less than can be expected to provide an adequate pension, exacerbating these risks.

The net result is that private pension provision in the UK is in decline, not only in terms of the numbers of people covered, but also in terms of the average level of benefits which is likely to emerge in future. If nothing is done, such provision is likely to continue to decline further in the years to come, as existing active members of closed DB schemes retire and if more DB schemes are closed. As one respondent put it to us, many employers are simply washing their hands of pension provision.

A further important factor is the 2012 reform programme, requiring employers to enrol employees into a workplace pension scheme, and the creation of a new Personal Accounts scheme. We

understand that the Government has designed the reforms to support the continuation of existing occupational pension provision, and that the Personal Accounts scheme will be targeted at moderate to low earners without access to a good quality scheme. We welcome this policy, and believe that our recommended changes will help to achieve that continuation.

We believe that two important reasons for the flight from DB schemes in recent years have been the ever-increasing regulatory burden surrounding them and the fact that they often represent an open-ended burden of risk for the sponsoring company, leaving it exposed to unlimited extra costs, for example from poor investment performance or improved longevity. By contrast a DC scheme provides relative simplicity, leaving employers free to concentrate on their main business activities, and any long-term risks for the company and employees are often forgotten.

If these two problems of DB schemes (regulatory burden and open-ended risk) could be alleviated sufficiently, this would make it easier for companies to consider DB schemes, or at least an element of DB provision, once again. Some might well do so, because there are several important long-term advantages for many companies in having a DB scheme, including better recruitment and retention; the significantly lower risk than in a DC scheme that retiring employees will expect the company to pay extra sums to bring their pensions up to adequate levels; and a significantly lower cost per unit of pension provided (because the scheme can follow a diversified long-term investment policy for the membership as a whole, leading to higher returns than from a DC scheme, where investment in bonds will be needed for much of the employee's lifetime).

These advantages will not, of course, weigh heavily with all employers, but many may wish to consider the arguments again when they next review their pension arrangements, if the regulatory burden and the extent of risk in a DB scheme have by then been eased. There will then be a more level playing field as between DB and DC, leading to solutions which are better for both companies and employees.

We have therefore placed the emphasis in our recommendations on:

- encouraging the introduction of risk-sharing DB schemes, where the employer is unwilling to bear all the risks on an open-ended basis;
- removing or easing regulatory obstacles in DB schemes which are hindering sensible courses of action by companies (such as some of the employer debt regulations, and regulations restricting to an unreasonable extent the ability of the employer to reclaim any surplus which arises);
- moving towards simple outcome-related principles in some areas of regulation, leaving companies and trustees free to achieve these outcomes in their own ways, with resulting economies and efficiency, and hopefully a greater understanding by pensions professionals of what outcomes are required.

Since some companies will undoubtedly wish to continue with DC schemes, even if it becomes less onerous to have a DB scheme, we would also encourage the Government to examine ways in which some of the risks for the members of DC schemes could be lessened where the company is willing to do so.

None of our recommendations would change the benefits of existing pensioners or deferred pensioners, nor would they change the benefits which have accrued up to now for today's employees or the age from which those benefits are payable. Our recommendations could, however, have an impact on the benefits which might accrue in future for employees, depending on the decisions made by their employers.

Our recommendations have been framed in such a way as to provide extra flexibility but not to rewrite the rules of the game. Those schemes which comply with the legislation as it now stands should be able if they wish to continue unchanged, without having to go through a new compliance exercise.

We recognise that some scheme sponsors will be disappointed that we have not done more to relieve them of their past service liabilities. However, we believe that if our recommendations are enacted, scheme sponsors will find operation of an occupational pension scheme easier, less expensive and less obtrusive into core business functions. Routine activities such as disclosure to members could be accomplished without resort to legal advice and would be simpler and more attuned to the needs of the scheme's members. The sponsor would be more relaxed about funding any deficits in the scheme through contributions (as opposed to expensive contingent arrangements) because funds in excess of requirements would not become "trapped" in the scheme. Corporate reorganisations and staffing changes among participating employers would proceed without protracted discussions with the trustees or the Pensions Regulator where the employer covenant clearly remained strong. The sponsor wishing to shoulder a limited risk would find that they have a number of ways to do so, and could proceed with confidence in implementing a plan that included targeted or contingent benefits. We think this more sponsor-friendly environment would influence sponsors to keep schemes open and initiate more employee-friendly provision.

Taken as a whole, we believe that our recommendations, if implemented, will make a significant difference to the regulatory scene. However, though they cover some of the issues of highest priority, they do not embrace every detail of the existing regulations which could usefully be amended. We therefore recommend that the DWP should continue its discussions with the main pensions industry stakeholders, with a view to identifying in due course the further changes which may be needed and keeping under review the progress which is being made towards converting the legislation to outcome-based principles where appropriate.

There is now an opportunity to send a clear signal to employers that the Government, by relaxing the regulatory burden along the lines we recommend, wishes to encourage sustainable occupational pension provision, allowing increased flexibility in order to meet the needs of both employees and employers.

Chris Lewin
Ed Sweeney
25 July

Deregulatory Review

Executive summary

The White Paper "Security in retirement: towards a new pension system", published in May 2006, contained a chapter on strengthening existing pension provision. A rolling deregulatory review of pensions legislation was announced and an advisory group of stakeholders was established to assist the Department for Work and Pensions ("DWP") in addressing concerns about pensions regulation. In December 2006, Ministers invited us to build on the initial analysis already carried out by the advisory group and to produce a report setting out recommendations for change.

Our terms of reference were to seek consensus on the balance between member protection and encouraging employer provision of pensions. This has been a difficult task in controversial territory in which many disparate views were expressed. However, we believe that the recommendations we put forward strike an appropriate balance and hope they are capable of achieving support.

We met with numerous stakeholders to gather evidence and issued our consultation paper in March 2007 seeking views on the various issues which had been raised with us. We received over 80 responses and have spent much time reading and listening to the many and varied representations made to us and considering the issues which were raised. We are very grateful for all the help received and the co-operation of those we specifically approached for further assistance.

Our aim has been to identify areas where legislative restrictions can be eased to encourage better funded, more sustainable pension provision for employees in the future. In some areas, it is clear to us that change is needed to ease the burdens on employers and those operating schemes; in others, we see scope for a more simplified approach. In different areas, we feel that the legislative requirements as they stand are appropriate but perhaps not fully understood and all that is needed is clarification to put the intended impact of legislation beyond doubt. We have not recommended changes in those areas where the legislation already seems to strike the right balance.

We carefully considered representations put to us that the cap on the revaluation of deferred pensions should be reduced from 5% to 2.5%. We both recognise the strength of the arguments for and against and on balance recommend no change. However, we acknowledge that there needs to be significant lessening of the current regulatory regime to encourage employers to continue to provide work based pensions. We would understand if Government took the view that, when looking at the package as a whole, a reduction in the cap from 5% to 2.5% was one of the measures needed to provide that encouragement.

There are a few areas where we were unable to reach agreement between us as to whether change is needed. We both, for example, recognise the strength of the arguments for and against the removal of the current requirement to provide limited price indexation ("LPI") after retirement, but have been unable to agree on whether removal would have the desired outcome in terms of encouraging continued strong provision through workplace-based pension schemes. Ed Sweeney believes that the case has not been made that employers would keep their defined benefit schemes open or adopt risk sharing approaches if LPI were abolished. Chris Lewin, on the other hand, believes that making LPI optional would open up important new avenues for risk-sharing and creativity in scheme design as well as encouraging scheme sponsors to continue to fund defined benefit provision.

We consider that significant changes are needed in relation to the application of section 75 of the Pensions Act 1995 to multi-employer schemes. Under the present regulations, a debt arises in many situations where it is unnecessary. For example, when the last active

member employed by a participating employer ceases active membership, we have suggested that there should be a “period of grace” of up to one year before any debt is triggered, and if the employer takes on a new active member in that period the debt should not be triggered. Where an employer participating in a multi-employer scheme withdraws, and the trustees (having taken appropriate professional advice) are satisfied that the covenant is not weakened, the debt should not be triggered, provided that the trustees are satisfied that the covenant is sufficiently strong to make it likely that the funding target will be met in due course. One of us (Chris Lewin) recommends that this latter proviso should be dropped, because it could lead to a situation where a relatively weak company is unable to restructure in a way which might save it.

Finally, we have been unable to agree concerning statutory indemnity for trustees. We agree that trustees are crucial to the occupational system in the UK, and that they should be supported and encouraged. However, one of us (Chris Lewin) believes that there is a real danger of a flight from trusteeship at short notice if a trustee who has acted in good faith suffers a personal loss, and that it would be prudent for the Government to do some contingency planning against this possibility

We examined whether legislation should be changed to accommodate the development of different types of schemes that do not fit into the traditional defined benefit or defined contribution framework. We are sympathetic to the idea that efforts should be made to develop a middle ground where employers and employees can share some of risks, although we are not attracted to the idea, which was put to us, of defining this middle ground in legislation.

We were surprised at the extent of flexibility for risk sharing schemes which currently exists. We nevertheless feel that there is scope for changes which would encourage new forms of risk sharing which would sit between traditional defined benefit and defined contribution schemes. This is particularly important in the current environment. We have made recommendations in relation to the PPF risk based levy and compensation, and proposed a clarification of the effect of section 67 which should introduce more scope for risk sharing schemes to flourish. As we note above, we have not been able to agree any recommendation in relation to mandatory indexation. However, if the Government decides to remove mandatory indexation to pensions in payment for future accruals, as one of us (Chris Lewin) recommends, this would provide even more flexibility in the design of risk sharing schemes by enabling them to “target” indexation without an open-ended guarantee of it.

Our recommendations are as follows:

- Accrued rights - No regulatory changes should be made which will adversely affect the position of pensioners or deferred pensioners at the present time or the past-service rights at the present time of active staff (paragraph 11).
- Risk-sharing in DC schemes – consideration should be given to permitting employers to prefund (with tax relief) any top-up payments they wish to make in order to supplement the funds available at retirement to DC scheme members (paragraph 34).
- Section 67 - We have concluded that the present formulation of section 67 should give sponsors and trustees sufficient scope to affect change. It has only been in effect for a little over a year, and time should be given to observe how it is being applied in practice. However, we would like to see DWP's rolling deregulatory review keep section 67 and the procedures it entails under consideration, and we would like DWP and TPR to consider publicly affirming that they are comfortable that our understanding regarding the application of section 67 is correct (paragraphs 38-48).

- Normal pension age – Schemes should be able to adjust normal pension age for pensionable service from now on and we believe that current regulations do not inhibit this (see comments on section 67 above), provided that the scheme rules are written in appropriate ways. We therefore make no recommendations in this area (paragraphs 49-61).
- Revaluation - We recommend no change in the statutory revaluation cap of 5% per annum compound for early leavers from most DB schemes, which maintains a fair balance between stayers and leavers (paragraphs 77-85).
- Trivial Commutation - The current regulatory difficulties regarding trivial commutation should be resolved by HM Revenue and Customs (HMRC) as quickly as possible (paragraph 82).
- Statutory override – We propose that legislation be enacted that will provide an override to restrictions on the amendment power where those restrictions would prevent schemes from changing their rules to allow benefit changes for future service where such changes are made possible by changes in legislation. We would extend this override to situations in which schemes have been unable to implement the Pensions Act 2004 changes to LPI (paragraphs 86-91).
- Compensation and risk based levy - We recommend that the DWP examine and further calibrate the basis for compensation to ensure a better match between PPF protection and the structure of risk based DB schemes (paragraphs 92-98).
- Principles based legislation - Renewed emphasis should be placed on a principles based approach to regulation of pensions, and in future the Department should prescribe required outcomes alone where appropriate, and make both rules and guidance more accessible and intelligible. Guidance should be developed to indicate some of the ways in which these prescribed outcomes can be met, whilst leaving employers and trustees free to find alternative ways that are efficient and meet the needs of their workforce (paragraphs 104-116).
- Disclosure and Rolling Programme - A framework of outcome-related principles accompanied by guidance, should take the place of the existing disclosure regulations. The guidance should set out some of the ways in which schemes could comply with the disclosure principles while making clear that the outcomes specified in the principles could be reached by other means. Schemes that comply with the existing legislation should be deemed to comply with the principles as long as their disclosure practice remains unchanged. If this approach to disclosure proves feasible and is considered an improvement on the current regime, the Government should consider other areas to which a principles based approach could be applied and establish a rolling programme (paragraphs 117-130).
- Surplus - The current provisions in section 37 of the Pensions Act 1995 should be amended to allow return of surplus to employers once the scheme has reached the scheme specific funding target and the trustees agree at that time that such a payment should be made. The existing explicit statutory requirement that the trustees must be satisfied that any surplus return is in the members' interests before giving their agreement should be repealed, on the grounds that it encourages overly conservative behaviour by trustees, who already have their fiduciary duties to observe (paragraphs 131-140).

- Employer debt - Where a company that participates in a DB multi employer scheme ceases to have employees actively participating in that scheme but the scheme continues, the debt should not be triggered if, within a period of up to one year, the employer acquires more employees who participate in the scheme (paragraphs 141-148).
- Employer debt - Where there is a group reconstruction of employers in a multi employer scheme, the principle should be established that the debt should not be triggered, where the original covenant was strong and if the remaining employers' covenant remains as strong, following the reconstruction, as the original covenant. The judgement as to whether the covenant remains intact should be the responsibility of the trustees, after taking appropriate professional advice. However, one of us (Chris Lewin) recommends that, where the original covenant is potentially weak, provided it remains unchanged after the reconstruction, the debt should still not be triggered (paragraphs 141-148).
- Trustees - The legislation should be amended so that individual trustees or trustee-directors are not required to have particular standards of knowledge or understanding on a range of issues. Instead each trustee board should be required to ensure that the board as a whole have sufficient knowledge and understanding between them to carry out their duties properly. The same should apply to any subgroup to whom trustee functions are delegated. In addition, we recommend that by overriding legislation a rule be inserted in all schemes that reasonable personal legal expenses of trustees that arise from the performance of their duties will be promptly reimbursed by the scheme, subject to the power of a court or tribunal to order that such reimbursement should be refunded to the scheme later (paragraphs 149-159).
- Pensions sharing on divorce - The policy and legislation regarding pensions and divorce should be reviewed with a view to making significant simplifications if possible (paragraph 163).

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Introduction

1. On 13 December 2006, James Purnell, the Minister of State for Pensions Reform, appointed us to work with the Department of Work and Pensions' Advisory Group, building on initial analysis and feedback captured in the Government's White Paper "Security in retirement: towards a new pensions system" (May 2006), to produce a report setting out recommendations for change.
2. Our terms of reference were:
 - *to examine regulation with the aim of simplifying and reducing the burden of legislation governing private pensions;*
 - *drawing on proposals from stakeholders;*
 - *seeking consensus on the balance between member protection and encouraging employer provision of pensions; and*
 - *having regard to appropriate legal and other constraints.*
3. Having met with a range of stakeholders, we published our consultation paper, "Deregulatory Review of Private Pensions: A Consultation Paper" in March 2007. We outlined some options for possible changes, inviting feedback by 6 April, in particular on the impact these changes would have on schemes' costs and on members' benefits.
4. We received over 80 responses covering all or some of the questions raised in our report, and held a consultation event in early April attended by around 40 stakeholders. Since then, we have followed up on many of the issues and ideas raised both prior to and as a result of the consultation.
5. This report sets out our recommendations for simplifying and reducing the burden of pensions legislation. It captures the key issues that were raised in response to our consultation paper, and seeks to show where there is possible consensus. It shows how the evidence we have received has impacted on our recommendations.
6. We have also drawn on previous pensions reviews – in particular the Pensions Law Reform Committee led by Professor Goode in 1993, Alan Pickering's report "A simpler way to better pensions" in 2002 and the Pensions Commission's first and second reports in 2004 and 2006. We were also in close touch with Paul Thornton who led the independent Institutional Review.
7. We continue to believe that private, work-based provision is essential to the well being of UK employees in retirement. If such provision is to flourish, we must foster an environment where employees receive adequate protection, while maintaining flexibility for trustees and employers to meet the pension commitment in fair and affordable ways. Getting this right should encourage employers to retain occupational schemes for their employees, and open the way for some to establish new schemes that balance risks in innovative ways.
8. Naturally, we have given a good deal of thought to the overall impact of our recommendations and suggestions. We have found it difficult to develop robust predictions of likely outcomes, because the outcomes would result from individual and scheme specific behaviour, which may or may not change as a result of what we are proposing and will play out over a long timeline. Each scheme will have its own special circumstances, most

especially demographics. The wider economic context plays a role too, where profits, investment and possibly employment could potentially be impacted upon.

9. Scheme sponsors have emphasised the need to reduce the cost of operating a pension scheme, and particularly a defined benefit scheme, in the UK. Others have strongly counselled against any measure that would undermine the benefits of members. Weighing these competing interests has proved complex because so much is dependant on driving behaviour in a system that is voluntary in nature, and it is difficult to measure the effect of any proposal. This has been brought home to us in our extensive discussions surrounding the possible removal of the requirement for any inflation protection for pensions in payment. Our proposals are intended to encourage scheme sponsors to commit to funding quality pensions for their employees, and where appropriate to consider mitigating at least some of the risks inherent in a benefit that will by its nature be exposed to circumstances that have not been foreseen or controlled by the sponsor or the member.

10. In making our recommendations, we are mindful that many respondents have expressed a preference for a period of stability in order to become accustomed to the new regulatory environment put in place under the Pensions Act 2004 and Finance Act 2004. They point out that the pace of change has itself been a cause of decreased confidence in the pensions system and that the cost of keeping up with changes has discouraged employers from occupational provision. We hope, however, that if our recommendations are followed, few, if any, changes will be required of schemes. Rather, our recommendations should in most cases result in additional flexibility for schemes, but no further constraints.

11. We also wish to thank the several thousand members of the British Airways Pension Scheme who wrote to us voicing concern that we might, among other things, recommend changes to accrued rights. They were not alone. The consultation response has overwhelmingly confirmed that our initial reluctance to support any measure that would interfere with pension rights already accrued was well-founded. Stakeholders across the full spectrum in the industry warned us that faith in the pensions system generally would be undermined if detrimental changes to accrued rights were allowed, even in pursuit of worthy goals. Therefore, our discussions below assume that any changes to current regulation will be made only in respect of service going forward after the necessary legislative changes are made.

12. Finally, we should like to thank all those who assisted us during the course of the review, including the members of the DWP's Deregulation Advisory Group, and the DWP Secretariat of Keith Roberts, Penny Pilzer (on secondment from Lovells), Kim Parsons, Mary Ball, Gabrielle Park, Ruth Saunders, John Kyriacou and, on the analytical side, Imran Razvi and Stephanie Rupp. Their work has been invaluable in helping to highlight the key issues and to suggest possible ways forward.

Risk sharing

13. In our consultation paper¹, we discussed many of the regulatory concerns of those operating and benefiting from current schemes. These have traditionally been either defined benefit ("DB") schemes, usually final salary schemes, where most of the risks are borne by the employer; or defined contribution ("DC") schemes², where most of the risks are borne by the member. We also asked for information about other models, where some risks were shared or undertaken in innovative ways. We wanted to know if there were instances in which the current environment was not only frustrating those providing

¹ "Deregulatory Review of Private Pensions: A Consultation paper" March 2007.pp7-8

² We use the terms "DC", "defined contribution" and "money purchase" interchangeably here.

traditional benefits, but discouraging those who were looking for innovative alternatives to the traditional DB and DC solutions.

14. We received many interesting responses to our questions about risk-sharing. Although in the last few years, many employers have turned to pure defined contribution schemes in order to reduce their liabilities and make them more predictable, many in the pensions industry believe that this will not be the path of the future. Some employers will no doubt keep their final salary schemes and some will modify them to take account of increasing longevity. Others will look for ways to retain some risk themselves on behalf of their employees, be it investment risk, longevity risk, or inflation risk in the retirement provision they offer. They will need to do so in order to recruit and retain the best employees.

15. We believe that employer involvement beyond putting funds into a defined contribution account can be beneficial to all. Employers can offer advantages of scale and sophistication that place them in a position to shoulder some risks in a more informed and efficient manner than individuals can do by themselves. For example, a pooled fund facilitates a long-term investment policy and allows benefits to be provided more economically in the long run. Certain financial risks, such as the risk of early death or retirement due to ill health, can be more equitably shared among the employer and the membership as a whole. On the other hand, most employers are reluctant to bear open – ended risks.

16. Therefore we were particularly interested in hearing about ways to maintain a balance between protection of the rights of members and the need to include flexibility. We were interested in hearing about ways in which the employer’s contribution to employee income in retirement can go beyond simply paying contributions into an account.

17. We asked stakeholders:

- whether employers would be inclined to take more risk than they would in the “pure” DC scheme if the regulatory environment was more flexible,
- if so, which risks they would be most willing to undertake, and
- whether there were regulatory obstacles preventing those who wish to take on these risks from doing so.

18. Scheme sponsors and their advisers were generally positive about increasing flexibility, some pointing out that tax simplification now allows additional creativity in benefit design. For the most part, the nature of the benefit in retirement no longer depends so entirely on the tax regime under which it accrued, and it is easier for employers to allow employees to draw pension while remaining in employment, perhaps part-time, as they age. Active members of occupational schemes may now simultaneously contribute to personal pensions, and tax advantaged annual contributions to DC schemes can be higher, allowing high contributions in “good” years to balance out leaner periods in which an individual may have had other, more pressing, demands on their income. The effects of the new freedoms are only now starting to be tested.

19. Many employers say that they would be interested in building on the increased flexibility on the tax side to design plans that mitigate some of the risks to employees inherent in “pure” DC provision, but are frustrated by a system that retains many of the cumbersome rules and practices that developed in the context of traditional final salary provision and which apply to all benefits which are not “pure” money purchase.

20. We will be looking into each of these obstacles further in the course of our report. It is probably worth noting at the outset, however, that much of the evidence presented to us indicates that the current system retains more flexibility than is often suggested. We were

happy to be assured that the changes recently made to section 67 of the Pensions Act 1995 seem to allow schemes more freedom regarding changes in scheme design, especially going forward, than many suppose. That said, there is scope for removing unnecessary or outdated obstacles altogether.

21. We also are aware that unions and pensioner representatives are more sceptical about deploying “risk-sharing” approaches than are employers and trade associations. Member representatives observe that members increasingly have been sharing costs and risks with employers, and that many of the so-called obstacles to risk sharing were introduced as member protections, without which members could lose out. We were warned that we should be wary of introducing new “flexibilities” that could simply translate to benefit cuts in existing schemes, with little likelihood that rates of scheme closure would slow down or the pace of innovation would increase.

22. Finally, we are aware of the growing distance between the dwindling number of employees who retain solid pension entitlements, and those with inadequate or no pension provision. Much of what we advocate here will be with an eye to encouraging employers to continue to provide retirement benefits, and to improve the benefits that they do provide.

23. We have kept all of these viewpoints in mind as we review some of the more specific proposals for freeing up pensions provision from regulation that impedes good scheme design.

PART I RISK SHARING

A. Risk Sharing Schemes

24. The present system, although criticised by many, offers a variety of ways to provide a pension. We are all familiar with the final salary scheme, in which the member earns a proportion of his or her salary at retirement to be paid as annual pension in retirement, and the employer normally ensures that the scheme remains solvent, no matter how much the promised pension turns out to cost. Similarly, there is a general public understanding of a “pure” DC scheme, in which defined contributions are invested, to build up a fund that can be converted at retirement into a stream of income the amount of which cannot be forecast in advance with confidence. However, between these two extremes are a number of possible variations.

NAPF case studies

25. The National Association of Pension Funds (“NAPF”) has recently published a short series of “case studies from the changing world of occupational pensions.” (See “All Change!” published May 2007) that highlights the many approaches that employers who wish to provide good pensions can take. The paper describes seven possible approaches to provision, including:

- a career average scheme³,
- a scheme that offers a choice of accrual rates to participants;
- a scheme in which the member bears some of the longevity risk by the application of a “longevity factor” to the benefit payable⁴; and
- a cash balance scheme⁵

³ A career average scheme is much like a final salary scheme except that each employee earns a proportion of his or her salary in each year to be paid as annual income in retirement. Unlike final salary schemes, career average schemes do not require adjustment in deferment to take account of wage inflation, although many do make such an adjustment for leavers and stayers alike. A career average scheme will usually yield a lower income at retirement, especially for “high fliers” because retirement income is based in part on the income earned earlier in the member’s employment with that employer. When we refer to salary based schemes in this paper, we mean both final salary and career average schemes.

⁴ The longevity factor is applied to a salary based benefit so that income from the accrued benefit is paid out in accordance with projected longevity at retirement. Such a factor would reduce income if longevity is projected to rise at retirement (in relation to longevity when the benefit began to accrue on this basis), but would increase if longevity fell.

⁵ There are a number of types of cash balance scheme. The scheme described in the case study is one in which the employer guaranteed an investment return by promising a cash sum at retirement equal to 20% of salary, with a capped inflation adjustment and discretionary uplift, for each year of participation. Schemes commonly called cash balance schemes sometimes include a guaranteed annuity rate at retirement instead of a guaranteed investment return, or smooth returns applied to the DC pot.

All of the above approaches are possible under current regulation. However, we have been intrigued by descriptions of other kinds of plans that we are told could flourish in a modified regulatory environment.

The ACA's proposed risk sharing plan

26. The Association of Consulting Actuaries (“ACA”) has proposed that a regulatory framework be designed to allow a third type of scheme, neither traditional final salary nor defined contribution. Members would accrue benefits on a career average basis. They would be informed that the normal pension age (the age at which benefits may be taken without reduction for early withdrawal)⁶ could move where the actuary found that improving longevity supported such a move. In this way, longevity risk prior to retirement would be shared between member and sponsor. Investment risk would be shared because revaluation of the benefit earned and uprating of pensions in payment to account for inflation would be targeted rather than guaranteed, and payable only where, in a given year, the scheme’s funding allowed them to be paid. Scheme funding, in turn, would need to be very close to full funding (on an ongoing basis) at all times.⁷ Some of these features would be allowed under the current framework.

27. The ACA note that the current regulatory environment impedes this design in several ways, including:

- postponing or decreasing the annual income available from the accrued benefit (due to the shift in normal pension age) could be contested under section 67 of the Pensions Act 1995;
- the scheme funding regulations do not require the level of funding that would be required to allow the scheme to run fairly;
- the PPF levy relates to a compensation structure based on a final salary model that is more generous, which means that the levy may be higher than it would otherwise be if compensation more closely matched scheme benefits, and
- defined benefit schemes are required to pay pensions that rise with inflation, subject to a cap and this inflation protection cannot be made subject to the funding position of the scheme.

Cash balance schemes

28. We have also heard descriptions of DC schemes with features that would probably best be described as species of cash balance scheme. Typical suggested features included:

- an underpin, whereby the sponsor or scheme guarantees that if a certain investment return has not been achieved at retirement date, or if an annuity yielding a certain income cannot be purchased, the sponsor or the scheme will top up the member’s account to a level that would reflect that investment return or that annuity rate, and
- smoothing, whereby investment returns are held back to some extent in good times and applied when necessary to ensure that members who retire when the market is volatile do not suffer due to unfavourable timing.

⁶ Throughout this paper, when we refer to normal pension age we will mean the age at which defined benefits can be drawn without reduction.

⁷ A more complete description of the scheme is available on the ACA website, www.aca.org.uk under “Policy Statements”

29. Schemes having some of these features are being adopted, but we are told that the current regulatory environment discourages take-up for several reasons:

- any underpin or smoothing mechanism could be considered to accrue during a year of service, and thereby give rise to a benefit protected under section 67, making many future changes as difficult for these schemes as it currently is for defined benefit schemes;
- these schemes are treated as defined benefit schemes for the purposes of the PPF compensation and levy calculations (see also paragraphs 91-97), and
- the pension from such a scheme must include provision for increases in payment, based on inflation, because the scheme is treated as a defined benefit scheme under the legislation.

Contingent benefit schemes

30. Several respondents told us that they were interested in some form of contingent benefit arrangement whereby targets for some aspects of benefits are set, but the benefit ultimately depends on funding or some other contingency at the time of retirement. We have heard ideas for these schemes based on both defined benefit models (as the ACA scheme would be) and DC models (usually schemes that work much like cash balance arrangements).

31. The basic premise of such contingent arrangements is that an entitlement to a particular benefit will not arise unless a particular contingency occurs. Thus, an entitlement to an uplift in pension income based on inflation might depend not only on inflation, but on the investment performance of the scheme's fund, or benefits could accrue on a defined basis, but the age at which they could be taken without adjustment might rise and fall depending on expected longevity at or near the time of retirement. (Such a contingent benefit should be distinguished from a benefit that depends on the exercise of a discretion) We are told that current regulation makes these schemes difficult to implement because:

- there is concern that a court or ombudsman could construe the contingent benefits to be promised, and therefore protected under section 67 of the Pensions Act 1995;
- even if a defined benefit arises only on the occurrence of a contingency at retirement, the entire scheme could be considered a defined benefit scheme, subject to regulations that apply to final salary schemes and subject to a PPF levy designed for final salary schemes; and
- a favourite contingent benefit would be inflation protection for a pension in payment, and this is now required each year, regardless of contingencies, for pensions paid out of defined benefit arrangements.

32. A variation on this would be a scheme in which certain benefits become guaranteed only where the employer agrees, whether at retirement or some other date. Of course, such an approach is possible now so long as the employer's discretion is used only to augment the benefit.

Hybrid schemes and mixed benefit approaches

33. Many employers are also instituting or considering schemes or dual-scheme arrangements whereby an employee accrues benefits under one scheme or section of a scheme on a defined benefit basis, and in another scheme or section of the same scheme on a defined contribution basis. Under such an arrangement, the member has the benefit of

certainty for part of his or her pension, while a substantial part of his or her retirement income will depend on his or her willingness to save, and the performance of the market.

34. It may also be possible for an employer to prefund a defined contribution scheme on a tax relieved basis with an intention to top up employee accounts in order to supplement provision at retirement on a discretionary basis. We understand from informal discussion with HM Treasury on whether this would be in accordance with their policy, that they were unlikely to have an objection to such measures in principle, so long as they were not used to shield profits or in some other way as an opportunity for avoidance. We recommend that further consideration should be given to this idea, with a view to the issue of advice on what would be permissible.

Obstacles to risk sharing

35. Respondents confirmed that there are regulatory obstacles in the present system that made creativity in scheme design more difficult than it needs to be, including;

- uncertainty regarding the application of section 67 of the Pensions Act 1995,
- the very broad definition of DB scheme (in which anything but a pure DC scheme is subject to all of the safeguards and protections developed for a final salary scheme);
- inflexibility in PPF compensation and accordingly the levy; and
- legislation that requires pensions in payment to increase, up to a cap.

36. Other obstacles that concerned some respondents were:

- the constraints of the reference scheme test for contracted out schemes;
- the likelihood of miscommunication to, and therefore misunderstanding by, members concerning the risks that they would be shouldering; and
- a fear of future regulation and requirements.

37. We will be keeping all of these concerns in mind as we come to our conclusions regarding the questions raised on risk sharing. Before coming to these conclusions, we will deal in greater depth with some of the principal issues separately.

B. Section 67, Pensions Act 1995

38. Concerns about the application of section 67, Pensions Act 1995 (“section 67”), which protects accrued rights, ranked high on many lists as an obstacle to changes that would allow schemes to rationalise benefits and reduce costs. The current section 67 protects subsisting rights (rights to benefits which have accrued in accordance with scheme rules). Changes that are not detrimental to a member's subsisting rights are not affected by section 67 at all. Even a change that is detrimental may be made with the consent of the affected member (or without consent so long as each member retains benefits that are actuarially equivalent to those being changed).

39. We were asked to look at whether section 67 should be specifically disapplied in relation to certain pension promises, such as normal pension age, including promises made in the past. As stated above, we found little support for such a move. Therefore, we do not recommend disapplication of section 67 to any pension right once it has accrued.

40. Indeed, the premise on which this legislation is based – that benefits firmly promised and earned during periods of past service should not be changed unless the member agrees or receives equivalent benefits in exchange – seems unassailable. Nonetheless, many in the industry are concerned that section 67 is open to misinterpretation, and that a contingent promise could be construed to result in an accrued benefit even in circumstances where the contingency has not occurred. In this event, some fear, a court could hold section 67 to require a benefit to be paid, or paid at a higher level, than had been intended by those who established the scheme. This concern has often come up, for example, in the context of normal pension age, about which we will say more in the section on that subject.

41. We agree that so long as the rules are clear and members are fully informed, it should be possible for a scheme to make certain benefits contingent. However, after discussing this matter with several lawyers who specialise in pensions work, we believe the fear that section 67 will be misinterpreted is overblown. We understand that the weight of legal opinion is that where scheme rules are drafted correctly, section 67 should not prevent a benefit from being established on a contingent basis, provided that the benefit is linked to unambiguous events or indicators (including those that may move) and no power under the scheme can be invoked to move that indicator in a way that is detrimental to the member.

42. Furthermore, section 67 only prevents changes that are detrimental to a member. There is nothing in the statute to prevent the employer, with the trustees' consent (or vice versa, depending on the rules of the scheme) from setting benefits at a lower level than they hope to pay out, and augmenting the benefit on a discretionary basis when scheme finances permit. As an extreme example, a DB scheme could set the normal pension age at age 75 with the intention of allowing retirement without actuarial reduction at a much earlier age, provided scheme finances and longevity projections supported such an augmentation. We do not believe a scheme that engendered this degree of uncertainty would enable employees to plan for the future with any confidence and in practice we believe that most employers would look for more limited flexibility. Of course, employees should not be led to believe that an earlier date is the “real” normal retirement date - but it is not section 67 that would prevent the approach. Similarly, section 67 would not prevent the introduction of a flexible accrual rate, by “targeting” a particular accrual rate (on which the normal contributions would be based) but guaranteeing only a lower rate which would be written into the scheme rules and explanatory booklet, and on which any future recovery plans and PPF compensation would be based. The members would have to be fully informed of the situation from the outset and not misled in any way, and they would be updated at future valuations on the likelihood that anything more than the guaranteed rate of accrual could be afforded.

43. Nonetheless, there remains some unease that section 67 or the terms on which a scheme can operate under it may be misconstrued. Therefore we think that it would be appropriate for the DWP or TPR to confirm publicly that they would not regard section 67 as an impediment to schemes designed along the lines envisaged above. Of course, any clarification would need to make it clear that the Government would expect that employees are not misled into thinking that the guaranteed benefits will be more advantageous than is in fact the case.

44. As a separate matter, some scheme sponsors and administrators tell us that the procedures that must be followed under section 67 in order to make rationalising changes can be disproportionate. Even where small changes are contemplated to ease administration that may affect only a few members slightly, the consent of every possibly affected member is required, and may be difficult to obtain, especially since many will be deferred members. Where these members do not agree, the alternative - providing an equivalent benefit - can defeat the purpose of the exercise, and may reward the recalcitrant.

45. Variations on the current regime have been proposed. For example, we have heard proposals that:

- changes to subsisting rights should be allowed so long as actuarial equivalence is maintained over the scheme as a whole, and detrimental changes to any particular member is limited to a 5% tolerance⁸; or
- where consent had been obtained from at least 95% of the membership, the change should be applicable to all.

46. We understand the appeal of both of these proposals, but in the end believe that the number of safeguards that would be required in order to protect members' legitimate interests would make them just as cumbersome as the current legislation - which itself represents a very significant loosening of the prior restrictions.

47. The present configuration of section 67 procedures has been in place for only a little more than a year. Anecdotal evidence is that the procedures are being used by many schemes to allow rationalisation of benefits and even reductions. It seems to us, especially in view of the number of stakeholders who asked that we consider as few changes as possible, that it is too soon to tinker with the procedures for obtaining changes under section 67.

48. Recommendation: We have concluded that the present formulation of section 67 should give sponsors and trustees sufficient scope to affect change. It has only been in effect for a little over a year, and time should be given to observe how it is being applied in practice. However, we would like to see DWP's rolling deregulatory review keep section 67 and the procedures it entails under consideration, and we would like DWP and TPR to consider publicly affirming that they are comfortable that our understanding regarding the application of section 67 is correct.

⁸ This proposal is from the NAPF.

C. Changes to normal pension age

49. From the outset, we have been keen to hear how we could help schemes and their members respond to the challenge of increasing longevity. We asked for information concerning the ways that schemes, employers and employees are managing the transition to longer working lives. We were particularly interested in the feasibility of developing a standard longevity index that could be used in a factor applied to benefits at normal pension age (“NPA”), or in relation to which NPA could be set. (By “NPA” we mean the earliest age at which benefits can be paid from the scheme without any actuarial reduction for early payment.)

50. There was strong support from schemes and scheme sponsors for allowing schemes to change NPA for all periods of service, including past periods of service. The argument, explored in our March consultation paper⁹, is that this is effectively what the State has done in its proposals to raise state pension age, and so it should be allowed for the private sector as well. This would serve as a signal that employees should expect to work longer in order to support the substantially longer time at the end of life that they do not expect to be in employment. A slightly less radical idea, put forward by NAPF, would allow such changes only in relation to rises in projected longevity going forward. All of these suggestions are accompanied by agreement that some sort of safeguard would be required for those nearing retirement, which of course would mean further regulation and might fall foul of age discrimination rules.

51. We are not convinced that there is any need to abrogate the principle that benefits that have already accrued must be protected. Scheme sponsors already change NPA for service going forward, which has the effect of gradually phasing in a higher age at which the benefit is available without reduction. Many schemes have taken this route already. Other employers have dealt with the issue by seeking and obtaining member consent to working longer in order to maintain their benefit. However, these approaches require that NPA be changed periodically to account for changes in longevity, and unsettles employee expectations as to when they can retire with a “full” benefit.

52. It may be preferable to have a contingent or “floating” normal pension age that rises with state pension age or some other indicator of expected longevity. New schemes (and old schemes that put a new rule in place for service going forward) can link NPA to rising (or for that matter falling) projected longevity rather than accruing by having a set age. The actuarial value of benefits earned would not diminish, but the income drawn at retirement could vary depending on how long the benefit is expected to be paid out.

53. The approach to longevity instituted by BAe systems, described above and more fully in NAPF’s paper “All change!”, does just this. BAe developed and adopted a longevity factor that tracks changes in expected longevity between the start of participation in the scheme and the date on which benefits are claimed. It is then applied to the benefits when taken, so that the benefits taken at retirement reflect how long they are likely to be paid.

54. The idea of a longevity index is intriguing, and many of our respondents suggested that the Government develop a longevity index that could be used by schemes to set normal pension age. As we have learned, this would be a difficult proposition - different populations have differing life expectancies and any use of indices would need to be carefully tailored. And after all, the tables on which actuaries have relied until recently have proven to be inaccurate because projections of life expectancy, even across populations, are far from exact. Schemes may find it useful to develop their own guides, based on what their experts suggest for their particular populations, but we do not think that it is yet time to

⁹ “Deregulatory Review of Private Pensions: A Consultation Paper” March 2007, pp 14 - 15

suggest reliance on a particular index or to recommend that the Government Actuary's Department develop an index or set of indices beyond what is already available.

55. Another possibility might be to set NPA at a relatively late age (say 70) and then to enable employees to retire earlier than this without actuarial reduction at the discretion of the employer and/or the trustees. The normal contributions would be based on retirement at an earlier age (say 65), so as to provide reasonable grounds for hope that the exercise of this discretion could be afforded.

56. In any scheme design involving a variable NPA it would, of course, be necessary to ensure that age discrimination regulations were not infringed through the exercise of a discretion.

57. In all schemes it is of great importance that the members who have not yet retired should be made fully aware of the age when they are guaranteed to be able to draw their accrued pensions without actuarial reduction, even if there is a degree of uncertainty about whether they can do so prior to that age.

58. A further point is that while many employees have grown used to a set retirement age at which benefits are available, and many employers have found it useful for succession planning to have an age at which employees expected to leave and a benefit package that encouraged them to do so, the concept of a normal pension age set by the scheme at which the individual actually retires is probably outmoded. Respondents have told us that many employers have already responded to the Employment Equality (Age) Regulations 2006 and Finance Act 2004 by reducing the significance of NPA under scheme rules.

59. It has been very interesting to learn more about the ways in which the concerns raised by the Pensions Commission and others concerning the effect of rising longevity on scheme funding and pension planning are being tackled. We are encouraged that creative ways to deal with longevity risk for future service are being explored and implemented.

60. We do not believe the case has been made for altering current legislation to make changes to NPA going forward or across all service easier. It would appear that ways have been devised to deal with rising longevity, and no one has pointed to any particular aspect of the law that poses an insurmountable obstacle to creativity. Therefore, we believe that it is best to leave well enough alone.

61. Recommendation: Schemes should be able to adjust normal pension age for pensionable service from now on and we believe that current regulations do not inhibit this (see comments on section 67 above), provided that the scheme rules are written in appropriate ways. We therefore make no recommendations in this area.

D. Limited Price Indexation (LPI) of Pensions in Payment

62. One of the most controversial of the deregulatory changes we were asked to consider was whether increases to pensions in payment from DB schemes should be made optional for service going forward, as they were prior to 1997. Under the Pensions Act 1995, all pensions from most occupational schemes were required to rise each year in accordance with the retail price index, capped at 5%. The Pensions Act 2004 made increases to pensions from DC schemes optional once again, and lowered the cap for defined benefit schemes to 2.5%. We have considered whether LPI should be made entirely optional for service going forward from now on.

63. We start with the proposition that inflation-linked income in retirement is, for most members, a good thing. Despite the cap, it affords a degree of protection to those who are likely to need it. It may be that members do not value this protection, as indicated by the very low take-up rates for indexed pensions from DC schemes (where the feature is usually available but only if the member is willing to start at a lower initial income in retirement). However, pensioners are likely to appreciate inflation protection as they age, particularly if they live longer than they believed they would when they first retired. The effect on future income of the removal of the statutory requirement to increase pensions in payment was documented in our consultation paper.¹⁰

64. Balanced against this are arguments that all pensioners do not need this protection to the same degree, that it may be that a higher effective income earlier in retirement suits many pensioners, and that the employer should not be forced to fund an expensive benefit that members themselves do not value. It has been put to us that since price protection is not required for members of DC schemes, it is inconsistent to require it for members of DB schemes.

65. We have looked at the cost savings for scheme sponsors and these are substantial. It is difficult to get a reliable measure of cost savings, partly because take up rates are difficult to predict. However, the analysis that we commissioned indicates that if just 22% of active members in private sector DB schemes were in schemes that abolished LPI for service going forward, and the schemes stay open (because any cost saving will come from reduced costs for future accruals) savings to scheme sponsors would be in the neighbourhood of £1 billion per year. These figures extrapolate from those in our consultation paper, and are based on an “average” member, whose wage is £28,800 for the 2007 – 2008 tax year, and assumes a long term inflation rate of 2.9%.

66. Some respondents to the consultation are wary that removal of the LPI requirement would lead employers to simply remove it as a cost-saving measure. Of course, cost savings can be achieved in other ways - for example by introducing a lower accrual rate or pensionable salary, or a higher normal pension age. We do not mean to imply that these are preferable ways in which to achieve savings, but it may be the case that an employer who wished to cut costs would have taken such measures by now. Any cost saving measures would, of course, only deliver savings in schemes that are kept open to future accruals and such cost cutting may be preferable to scheme closure.

67. A strong argument for making LPI on pensions in payment optional is that such a move would be consonant with the general trend in the last few years to free pension design from legal restraints to as great a degree as possible. The Government, in enacting the Finance Act 2004, did away with many of the restrictions on scheme design and cleared away much of the confusion surrounding benefits by instituting a single tax regime applicable to all schemes. To many, making LPI optional would simply continue the trend towards peeling away governmental interference and allowing more choice. After all, there

¹⁰ “Deregulatory Review of Private Pensions: A Consultation Paper” March 2007, pp 10 - 11

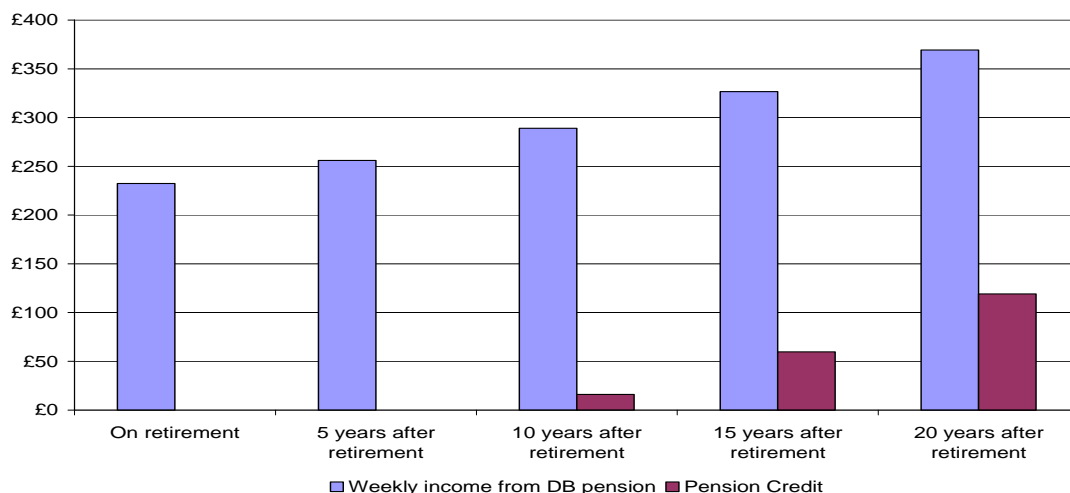
are many options that are good for pensioners and their families, including survivors' pensions, ill health pensions and guarantee periods. However, apart from the requirement for pensions for a surviving spouse or civil partner in contracted-out schemes, there is no statutory requirement to provide them.

68. Many respondents have said that LPI on pensions in payment, if no longer a statutory requirement, would be a perfect candidate for risk sharing by way of a targeted or a contingent benefit, payable when scheme funding allowed. Targeted rather than accrued LPI on pensions in payment is, for example, an important feature of the ACA's proposed third type of scheme. This is the way in which inflation linking on pensions in the Netherlands is accomplished. And this is, many point out, the way numerous schemes treated LPI in the past prior to 1997. Where scheme surpluses arose, which was often in times where inflation was relatively high, pensioners' incomes were given an increase. In many schemes, while the benefit was not promised, increases were regularly given, and the scheme was funded on the basis that such increases would be given annually.

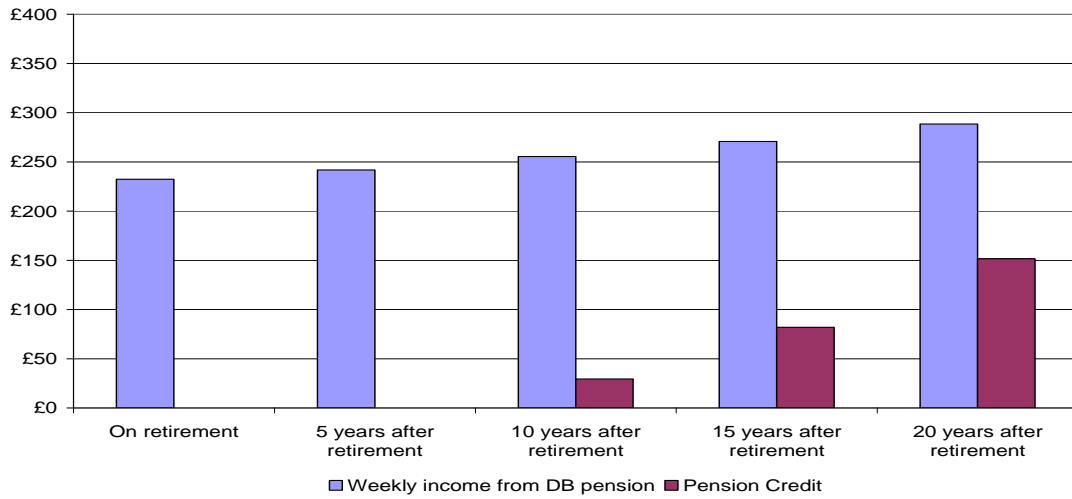
69. Finally, some believe that to remove inflation linking of pensions now would lead to more pensioners on state benefit. We looked into whether that is true, and it appears that while reliance on pension credit would be greater for some members of DB schemes, especially later in retirement, it does not begin significantly earlier. The following calculations assume that the pension credit system is post-reform as set out in the current Pensions Bill.

70. We assume, first, that a member currently earns £15,000 per annum and retires with 30 years of service from a contracted out final salary scheme in 2026. He has accrued at 1/60th of final salary per year, and has taken the maximum tax free cash lump sum on retirement. The graph below shows the income from the occupational scheme and from pension credit for this person five, ten, fifteen and twenty years after retirement, provided that he has no assets and his only other income is the basic state pension and any additional state pension to which he is entitled.

Weekly income from DB scheme and Pension Credit for someone retiring in 2026

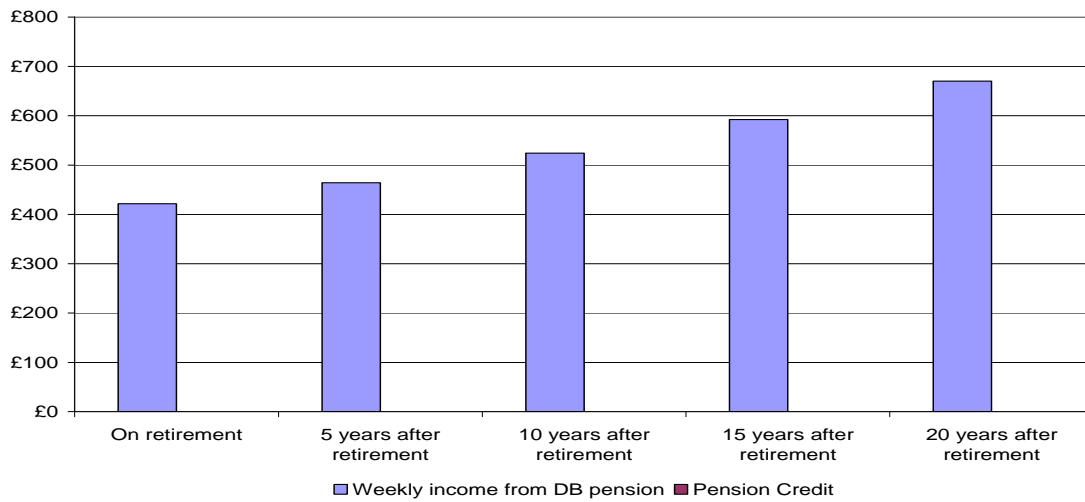


71. We now look at the comparative income in retirement for the same individual, assuming that his or her occupational scheme does not opt to continue LPI on pensions in payment, starting in 2008.

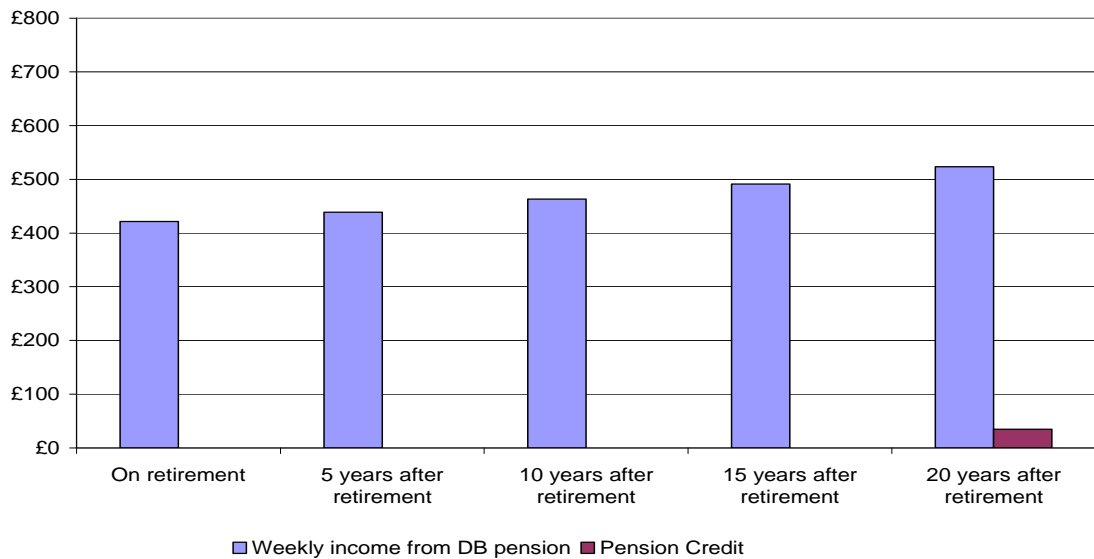


72. We can see that for this member, reliance on state pension credit is greater, but starts no earlier than it otherwise would.

73. We now look at the income from occupational and state benefits for a member who earns the average for a member of a DB scheme of £27,200 per year, assuming that LPI capped at 2.5% remains mandatory.



74. And here are the results if his or her occupational scheme does not opt to continue LPI on pensions in payment in 2008:



75. As we can see, this member becomes eligible for pension credit after 20 years in retirement. Our research shows that 30% of men who retire at age 66 will still be alive and drawing their pension twenty years later (assuming they have one), as will close to 40% of women. The analysis that we commissioned shows that relaxing the rules on LPI increases pension credit entitlement by roughly another 0.5% - 2%.

76. We both recognise the strength of the arguments on LPI, but have been unable to agree on whether this change would have the desired outcome in terms of encouraging continued strong provision through workplace-based pension schemes. We therefore have been unable to make an agreed recommendation in this area. Ed Sweeney believes that this is a valuable benefit for members, that cost savings could be achieved in other ways, and is not persuaded that removing LPI will sufficiently influence employers to keep schemes open. Chris Lewin on the other hand believes that to retain this requirement impedes the development of risk-sharing schemes and therefore more sustainable pensions provision for the future. He considers it is important to give employers that flexibility over the shape of their pension provision, and recommends accordingly.

E. Revaluation of benefits in deferment

77. We were also asked by stakeholders to consider whether mandatory revaluation of deferred benefits in final salary schemes should be capped at 2.5% per annum for service going forward, rather than the current 5%¹¹. If additional final salary schemes close to accruals, much of the provision in them will be deferred in nature, and so this requirement is costly for such schemes. However, since we do not contemplate a change that relates to past service, the cost savings would not apply to current deferred employees, and the cost savings would not be as great as some seem to think. The 5.2 million current deferred members of private DB schemes would not be affected, because any change would only affect accruals going forward. Analysis we commissioned shows savings of the order of £200 million per year, although this is a very rough figure¹².

78. Once again, we find good arguments on either side of this question. Those who believe that an inflation-related rise in the value of deferred pensions is essential point out that a requirement to revalue deferred benefits in accordance with inflation has been on the books since 1986, and is integral to maintaining the pension promise. Without revaluation, employees who choose to leave their employer, and hence their scheme – or those who participated for a number of years prior to scheme closure – effectively lose much of the value of what they had earned in the scheme. The value of a benefit earned early in life would become worth very little by the time it came to be paid. Indeed, under the present arrangement, younger deferred members already tend to lose out because the benefit is linked to price inflation rather than wage inflation.

79. We asked whether, this being the case, job mobility would be affected if revaluation was capped at a lower rate because employees would be reluctant to change employment if their pension benefits earned with their first employer were not increased to reflect inflation to some extent. There seems to be a consensus that the level of revaluation would be unlikely to affect job mobility, many remarking that this would not be a priority consideration to an employee weighing up job prospects.

80. Those who think that there should be a reduction in the cap believe that it makes no sense to cap increases to pensions in payment at 2.5% while allowing increases to pensions in deferment, which for most schemes relate to ex-employees, to remain capped at 5%. Surely, these stakeholders argue, the leavers should not be rewarded more than the stayers. Others reply that this last argument misses the point - revaluation is designed to preserve parity between leavers and stayers, rather than as between leavers and pensioners.

81. We are not inclined to recommend a change in approach to the revaluation requirements for deferred benefits. Although there would be some cost savings for final salary schemes (partially offset by extra administrative costs due to the need to revalue two separate tranches of benefit at separate rates), these would be made entirely through reduction in the value of the benefits of those who leave the scheme before pension age. We have seen no evidence that this change would ease administration, encourage risk sharing or slow closure of final salary schemes. Although available data is patchy, it seems to us that women could be disproportionately affected by a reduction in the cap, because

¹¹ See "Deregulatory Review of Private Pensions, pp 12 -13, This statutory revaluation method does not apply in career average, cash balance or defined contribution schemes. The purpose of the defined benefit revaluation legislation is to provide some equality in treatment between members who stay, and whose benefit is linked to wages that will rise with inflation, and those who have left.

¹² The figure assumes 280,000 members of private DB schemes (of which most would be final salary schemes) go into deferred status each year (this is based on evidence from the 2004 and 2005 GAD Occupational Pension Schemes Survey); that they have on average 7 years service prior to becoming deferred, and that the benefits remain deferred for at least 25 years. Our inflation assumption is 2.9%.

they are more likely to earn pension benefits early in their careers and then leave the workforce for periods of time to undertake caring responsibilities.

82. We would like to note here that a number of stakeholders complained about the difficulties posed by deferred benefits generally. One problem brought to our attention has been the expected build up over time of large numbers of small benefits that can no longer be commuted (or can only be commuted after considerable administrative effort) due to changes in the tax laws. We brought these problems to the attention of HMRC, and were told that the Government plans to explore the way in which the current rules on trivial commutation impact across a range of interests bearing carefully in mind both the potential impact on individual pensioners, pension savers and pension providers and the way the rules fit with the Government's wider objectives in encouraging pension saving to produce an income stream in retirement. We were assured that these discussions are continuing. It is important that the difficulties in this area are removed as soon as possible.

83. We were also asked to consider ways to make the transfer process more simple, some suggesting that transfers without consent to personal pension accounts be allowed. We understand that this raises problems under EU law, and particularly regulations on passive selling. However, it is possible that a solution may be found in relation to automatic enrolment in personal accounts in 2012, and we hope that consideration will be given to extending any solution found for personal accounts to this problem as well.

84. Obstacles relating to the transfer of Guaranteed Minimum Pensions (GMPs) have also been brought to our attention. Some of these relate to equalisation of benefits under European law and are outside our purview. However, we note that the current Pensions Bill contains provisions allowing GMPs to be converted to scheme benefits at actuarial value, which may help some schemes and also contains measures aimed at allowing scheme members to transfer GMPs more easily. These measures are encouraging, and we recommend that the rolling review keep this area under observation until changes introduced by the current Pensions Bill have bedded in.

85. Recommendation: We recommend no change in the statutory revaluation cap of 5% per annum compound for early leavers from most DB schemes, which maintains a fair balance between stayers and leavers.

We recommend that the current regulatory difficulties regarding trivial commutation should be resolved by HMRC as quickly as possible.

F. Statutory override

86. We asked for views regarding statutory overrides to scheme documents where the documents prevent even changes to benefits for future service¹³ and a variety of views were received. Those who favour override do so on the ground that the playing field between employers is not level as to pensions, largely due to historical accident, and this could cause some employers to have higher costs than others in the same industry leading to price distortion and job losses. Those against pointed out that in most cases the rules forbidding future changes were there for a reason - and that often that reason was a negotiated promise in the context of privatisation.

87. There is little appetite for overriding legislation that allows unrestricted future changes to benefits, and next to none for legislation allowing changes to past accruals (although several respondents pointed out that section 67 would protect past accruals even if scheme documents were overridden). However, there was support for allowing all schemes to take advantage of any new flexibilities that are introduced through law. Particularly, it has been brought to our attention that many employers who might have wished to take advantage of the change to a 2.5% cap on LPI have not been able to do so due to restrictive language in scheme documents, creating an uneven playing field even among employers who provide good DB plans.

88. Like most respondents, we believe that any statutory override must be narrowly drawn in order to assure that the balance of power intended under scheme rules is maintained as much as possible and that there are few unintended consequences. However, we feel that there is a good case for allowing all schemes to take advantage of regulatory relaxations as they occur, in order to promote both flexibility and fairness between employers. This could be accomplished, for example, by allowing trustees to change scheme provisions by resolution under section 68 Pensions Act 1995 in much the same way it was accomplished for Finance Act 2004 changes. However, we consider that such an override would only be appropriate where the employer and trustees agree¹⁴.

89. We also considered whether it would be worthwhile giving the Pensions Regulator power to approve any kind of rule amendment which is agreed by both the employer and the trustees and where at least, say, 90% of the scheme members affected by the amendment have voted in favour. The Regulator would only be able to approve the amendment if it was satisfied that any members affected who had not voted in favour would not be significantly worse off in respect of their accrued benefits. We did not, however, reach a firm conclusion on this.

90. Recommendation: We propose that legislation be enacted that will provide an override to restrictions on the amendment power where those restrictions would prevent schemes from changing their rules to allow benefit changes for future service where such changes are made possible by changes in legislation. We would extend this override to situations in which schemes have been unable to implement the Pensions Act 2004 changes to LPI.

91. We understand that prohibitions on changes to benefits accruing in the future can sometimes be the result of negotiation in the context of privatisation. It will be up to the Government to consider whether it is appropriate to extend the override to these situations, or rather to omit these schemes from any override that is adopted.

¹³ "Deregulatory Review of Private Pensions: A Consultation Paper" March 2007, pp18 – 19.

¹⁴ It has been brought to our attention that some paid up schemes administered through insurance companies have been unable to implement Finance Act changes, including those that would be helpful to members, due to the absence of an employer with whom to agree changes. We believe that this problem should be addressed as well.

G. PPF Levy and Compensation

92. We noted above that the Pension Protection Fund levy and compensation were often listed as an impediment to development of risk sharing schemes. This is so because any scheme that incorporates any kind of employer promise or underpin will be classified as a non-money purchase scheme that is covered by the PPF and subject to the levy.

93. Under the Pensions Act 2004, PPF compensation automatically incorporates the features of a final salary scheme in which all benefits ceased accruing when the scheme terminated. Compensation is based on the pension income that would have been available from the scheme immediately after retirement (based on accruals prior to termination only), and also includes revaluation of deferred pensions and an element of inflation protection for pensions in payment. The pension income on which compensation would be based often cannot be determined in relation to a cash balance scheme, or one in which a longevity factor is applied at retirement. This can result in unfairness.¹⁵ (Hybrid schemes do not pose the same difficulties because it is possible to separate the DB from the DC element).

94. We take the view that the risk-based levy does not in itself prevent risk sharing approaches, but may impose disproportionate costs on schemes that do not provide benefits on the traditional DB basis. Cash balance schemes are particularly hard-hit by the disconnect between the benefits guaranteed and the calculation of compensation and levy.

95. We understand the reasons for adopting a one-size-fits-all model when the levy was first imposed, but now that the system is up and running, it is probably time to fine-tune the approach, so that both compensation and levy more closely reflect the promise actually undertaken by the scheme and its sponsor.

96. In some circumstances, it may make sense to base compensation on the value of the accrued benefit. We know that this will mean some hard thinking about how the accrued benefit should be valued for these purposes, but valuation of accrued benefit is a much-mulled topic already and it should not be impossible to come up with principles for doing so. Any compensation could be paid in a uniform defined benefit format, but these payments would be based on the value of the benefit accrued in the scheme.

97. If necessary, the Pensions Act 2004 should be amended to allow both compensation and the levy to reflect the guaranteed benefit level and the risk profile of the scheme, based on the promises that have been given.¹⁶ We note that some flexibility has been given to the Government to modify the schedule setting out compensation "in prescribed circumstances"¹⁷. This power was apparently given in order to allow accommodation for cash balance schemes¹⁸. In any case, we think it is time that the Government examines the basis for compensation and the risk-based levy to assure that there is sufficient flexibility in the calculation of compensation and levy to accommodate the existing arrangements such as cash balance schemes and the development of new approaches.

98. Recommendation: We recommend that the DWP examine and further calibrate the basis for compensation to ensure a better match between PPF protection and the structure of risk based schemes.

¹⁵ Even in more traditional schemes, compensation may not reflect the value of the pension. For example, in a scheme offering a bridging pension, compensation will be based on the higher starting income from the scheme rather than the lower income that will apply at state pension age.

¹⁶ See section 162 and Schedule 7, Pensions Act 2004.

¹⁷ See paragraph 33, Schedule 7 Pensions Act 2004.

¹⁸ See paragraph 206, Explanatory Notes to Pensions Act 2004.

H. Conclusions regarding risk sharing

99. We have heard a number of important and well-thought out ideas regarding ways in which at least some of the present financial risks inherent in defined benefit provision can be managed through risk sharing approaches. We hope that there will be follow-through on our recommendations that will facilitate a wider range of risk sharing designs, and that this results in increased interest from employers in going beyond pure defined contribution provision.

100. We have not endorsed the use of any one approach to risk sharing. Particularly, we have not endorsed any approach, like that put forward by the ACA, that the Government initiate a new set of regulations, with a third set of restrictions and mandates, favouring a particular mode of provision. We understand the reasoning that a particular risk sharing scheme, if enshrined in regulation, would be adopted in a more uniform way and for that reason may be more easily understood. We also understand that a good deal of thought has been given both to the safeguards for employees and to the freedoms for sponsors that this third sort of provision should entail. But we think that at this point freedom of sponsors to tailor their approaches would be more beneficial than freezing a particular approach in another layer of law. This simply would not be in line with our terms of reference, which strongly underline a deregulatory purpose.

101. Particularly, we do not think that a separate fund within the PPF should be established for risk-sharing schemes, or a particular species of risk sharing scheme. We hear that some employers are reluctant to establish any scheme with a defined benefit component because they fear that they will be required, through the levy, to fund past service liabilities of more longstanding schemes. We believe this fear is unfounded - the new forms of risk sharing that we have learned about, including the ACA proposal, would be funded to a higher level in respect of the basic guaranteed benefits than most DB schemes. As PPF levy is related to scheme deficits, this would mean that they would pay less risk-based levy than others. For similar reasons, we do not think a completely different funding regime is necessary for these schemes. We believe the different goals and guarantees of such schemes should be accommodated in a scheme's funding principles and technical provisions under the current regime if there is a desire to do so.

102. We have considered how contracting-out of the State Second Pension Scheme could be accommodated in a risk sharing scheme. The legislation already provides that a contracted-out scheme need not follow the reference scheme exactly, as long as, under the reference scheme test, it provides benefits broadly equivalent in value, and includes a 50% spouse's pension. Hence if a risk-sharing scheme provides an appropriate guaranteed underpin, this should enable it to contract out if there is a desire to do so.

103. We hope that scheme sponsors will see merit in schemes similar to that proposed by the ACA and that if our suggestions are adopted, this will not only be possible, but appealing. We understand that if the Government decides not to remove the requirement for LPI this will prevent some designs of risk sharing schemes, but others will still be possible.

PART II: PRINCIPLES BASED REGULATION

A. Principles based regulation and pensions

104. We asked for opinions on principles based regulation. A minority of those responding to our queries cautioned that any change in approach would be likely to do more harm than good because another deluge of new regulations, however well-intentioned, is the last thing beleaguered scheme administrators need. On the other hand, many respondents agreed that it would be worth trying a principles based approach, at least in a few “test bed” areas.

105. As we said in our paper¹⁹, principles based regulation means different things to different people, and this became clear as we tested our responses. According to the Financial Services Authority (“FSA”), it means “where possible, moving away from dictating through detailed, prescriptive rules and supervisory actions how firms should operate their business”²⁰. The FSA hopes that as it moves towards a more principles based approach “[no] longer will regulation be seen as a side-line occupation that imposes costs in addition and in parallel to business costs; it will be seen as an integral part of business decision-making”.

106. Many respondents who see principles based regulation as the FSA does are uncomfortable with its application to pensions. After all, pension provision is voluntarily undertaken by employers for a variety of reasons, none of which is central to its purpose or core operations. These respondents worry that in addition to the costs inherent in any change, a principles based system may require more time, resource and effort to understand and implement than sponsors are willing to commit. They believe that the focus on individualised outcomes is fine for larger schemes with staff committed full time to pensions, but that smaller schemes are likely to need additional professional advice in order to forge a bespoke approach, which would be burdensome. These schemes, it is said, need certainty above all. These are very reasonable concerns.

107. We realise that there are risks to a principles based approach - the two most worrying are that member safeguards may be undermined and that sponsors will be uncertain as to how the law will, in the end, be enforced. Nor do we underestimate the difficulty of articulating and implementing principles, and resisting the temptation to legislate good practice.

108. That said, we remain attracted to an approach to regulation that is focussed on outcomes. Like many, we associate a principles based approach with what has become known as “Better Regulation”, including an emphasis on proportionality, accountability, consistency, transparency, and targeting. We think we are part way there already in the approach that has been followed by TPR in codes and guidance, and in the way HMRC’s guidance in the Registered Pension Schemes Manual is set out. We were pleased, as were most respondents, by the approach taken to the legislation regarding member nominated trustees. But we think that more can be done to make pensions regulation easier to understand and less heavy-handed in implementation.

109. Specifically, we wonder whether all of the current layers of regulation affecting occupational schemes are really necessary. At present, we often are confronted by a statute, regulations, a code²¹, and guidance, all attempting to instruct the scheme

¹⁹ “Deregulatory Review of Private Pensions, A Consultation Paper,” pages 20 – 21.

²⁰ Page 4, “Principles-based regulation: focusing on the outcomes that matter” FSA, April 2007.

²¹ A code of practice is not enforced in the same way as regulations. Although non-compliance with a code of practice does not of itself render a person liable to legal proceedings, the code is admissible in evidence, and non-compliance can be used as evidence of wrongdoing. See Section 90(5), Pensions Act 2004. Guidance, on the other hand, acts more in the way of practical

administrator concerning one aspect of a particular pensions-related activity. Surely we do not need to say the same thing so many, sometimes conflicting, ways. Specifically, we do not think that both a code and a set of regulations should cover the same area.

110. The Occupational Pension Schemes (Scheme Administration) Regulations, which attracted some comment, are a case in point. Do we really need regulations setting the “manner of, and time for giving, notice when a specified number of trustees must be present for a decision” at all? If we do, wouldn’t it be better to subsume this in a code of practice by TPR rather than putting together a separate set of regulations? It seems to us that most of what these regulations accomplish in a substantive sense is also addressed in the current Codes of Practice on Trustee Knowledge and Understanding or Internal Controls – or easily could be. We understand that these regulations correspond in many places to statutory requirements that certain matters be “prescribed” or provide exemptions from requirements, and that they may therefore be helpful or necessary in the context of statutory language. Nonetheless, we suggest that, given the range of codes and guidance from TPR regarding the conduct of scheme business, it would be useful to think about whether all that is being prescribed (whether as a result of statutory imperative or not) needs to be prescribed and whether there are ways to cut down on the number of instructions to trustees and administrators, and the number of places in which instructions are being given.

111. An incremental approach to change is probably best, given how much upheaval there has been in pensions regulation in the last few years, and there seems to be some consensus that disclosure would be the best place to start.²² We discuss how we think that a principles based approach might look in the context of disclosure below. But it is important that it should not stop there. Principles based legislation has been advocated by both the Goode Committee and Alan Pickering, but the majority of new legislation has continued to be complicated and prescriptive.

112. For this reason, we would like DWP to undertake to examine both primary and secondary legislation each time new approaches are recommended, substantive changes are proposed, or reviews are initiated, with an eye to removing requirements wherever they are not necessary, and avoiding prescription in regulations or in codes where guidance could be as effective. Layers of regulation should be streamlined, and particularly, a choice should be made between regulating through regulations or codes of practice - there should never be both in the same area. We would like to see DWP or TPR, as appropriate, articulate the result that is being sought and why the result is more likely to be attained through the method chosen. We note that TPR is already doing this to a great extent, and would like to see the approach adopted for all pensions regulation. We also think there is more scope for TPR to issue helpful guidance, compliance with which will be evidence that the scheme has complied with the specified principles, but leaving schemes free (if they wish) to achieve the outcomes in other ways which are more efficient or better suited to the needs of their workforce

113. Circumstances may sometimes arise where a future change in the legislation necessitates the prescription not only of principles but also of detailed instructions on how the change should be implemented. In such circumstances consideration should be given to the inclusion in the initial legislation of the outcome-related principles on which the change is based, relegating the detailed implementation instructions to a schedule which will have an automatic “sunset clause” under which the schedule will expire at a future date.

assistance. Guidance could be prayed in aid by the trustees as evidence of having met the principles, but equally trustees would be able to depart from guidance where it made sense for their scheme.

²² Transfers and preservation, member-nominated trustees, governance and consultation with members were other areas suggested to us, although disclosure was the popular choice by some distance.

114. When promulgating replacement regulations, codes or guidance, attention should be paid to the principles of plain English in presentation. Although we accept that legal interpretation will continue to be necessary, we would hope that any regulation, code or guidance would set out what principle is being served, and what is and is not likely to be permissible. Much of the regulation currently on the books refers in and back on itself repeatedly or requires that the reader return to other parts of legislation and insert words or phrases. This should be avoided. The aim should be to enable a pensions professional who is not a lawyer to understand the meaning of each regulation without having to refer to legislation elsewhere.

115. Finally, we know that scheme administrators have already been presented with more new regulation over the past two years than they have been able to digest comfortably. We would not wish for any new approach to add to their travails. For this reason, we suggest that DWP should focus on rationalising and simplifying the present regime rather than replacing it wholesale. It should be possible to construct any principles based legislation and guidance so that there is a built-in grace period of some number of years for those whose practices fit within the former regime. In addition, there will need to be sufficient guidance to allow small schemes to follow the law with minimal cost in terms of time or consultant's fees.

116. Recommendation: Renewed emphasis should be placed on a principles based approach to regulation of pensions, and in the future the Department should prescribe required outcomes alone where appropriate, and make both rules and guidance more accessible and intelligible. Guidance should be developed to indicate some ways in which these prescribed outcomes can be met, whilst leaving employers and trustees free to find alternative ways that are efficient and meet the needs of their workforce.

B. Disclosure

117. Disclosure to scheme members is an area in which box ticking, as opposed to thoughtful communication, can be downright harmful. For that reason and others, we feel that this area of legislation is ripe for a principles based framework.²³ Disclosure requirements applicable to communications with the membership of occupational schemes currently reside primarily in the Occupational Pension Schemes (Disclosure of Information) Regulations 1996, but are also scattered among at least a dozen other regulations and codes of practice. Many stakeholders have commented that even where they are gathered together, the regulations are unnecessarily complex and difficult to read, given the relatively straightforward nature of the directions they are supposed to be giving. Others have made a plea for harmonisation of the approach to occupational and personal pensions.

118. We believe that especially as schemes move in the direction of innovation and risk sharing, effective disclosure will be crucial not only to members' understanding of the level and shape of their benefits, but to the extent of a scheme's or employer's obligations. As benefit configurations become more diverse, the risk of misunderstanding increases. We would not expect a scheme administrator to prevail before a tribunal with an argument that the member's actual entitlement differed significantly from what he was given to understand. Conversely, we would not expect that a member should need to take a case to a tribunal in order to get a cogent explanation of his or her entitlement and how benefits accrue.

119. We would like to see whether it is feasible to create a more accessible and less prescriptive method for dealing with disclosure obligations. A recent study of the administrative burdens imposed by DWP on business costed the two main sets of disclosure regulations as imposing burdens in the region of £56 million. While member communications will remain a significant expense, we believe that adoption of a sensible and straightforward regulatory framework would be a good place to start in an effort to bring unnecessary costs down.

120. We did not achieve any consensus among those polled regarding how a principle relating to disclosure might be expressed. However, we have, after some thought, come up with a proposed approach. Our proposal is that DWP put together one set of regulations relating to disclosure, or ask TPR to put together a Code of Practice on disclosure, accompanied by guidance, which would supersede all of the existing regulation on disclosure without requiring large immediate changes in present communications practice. This approach should allow those who have strong ideas concerning the methods of communication that best suit their membership to communicate in the ways they believe will be most efficient and effective, while giving a level of comfort to those who would prefer more comprehensive direction from TPR.

121. We also have given some thought to what we think the principle and associated requirements should look like. The principle could be along the following lines: "Members should be given sufficient information that allows them to understand the benefits to which they will be entitled, and that will enable each member to make decisions in his or her own best interest".

122. Going down another layer from the principle, we would favour guidance or general requirements calibrated to the various stages in a member's career, which we see as being

- on joining,
- when leaving active membership and

²³ Reporting and disclosure to TPR or other regulatory bodies is probably a place where clear instructions are appreciated, and therefore we only discuss disclosure to the membership here.

- when making decisions about drawing the benefit.

In addition:

- Important facts about the member's provision should be sent to that member periodically;
- The member should be informed when conditions relating to benefit accrual or entitlement change;
- The member should be informed of key events (closure of the scheme, wind-up for example), and
- The member should be given information concerning dispute procedures and contact details for The Pensions Advisory Service and the Pensions Ombudsman.

123. We would like to see each of these circumstances addressed, as outlined in the following paragraphs. We emphasise that our suggestions here should not expand on what is now required - we would hope only to specify minimum requirements which are more accessible, straightforward and flexible. We intend that where schemes and employers are already complying with the current disclosure regime they should have the reassurance that they are also complying with any principles set out.

124. The following should be provided when a member joins the scheme, set out in a single list:

- information about his or her rights to opt out of the scheme;
- a statement describing the contributions, if any, that he or she will be required (or able) to make and how they will be calculated;
- a statement that he or she will be contracted out of the State Second Pension Scheme, if this is the case;
- for DB schemes: adequate information about the method of calculation of the principal benefits for which the member and his or her family may later qualify, the qualifying conditions, and a risk statement describing any circumstance that may prevent those benefits from being paid, or paid in full;
- for DC schemes: the terms of any employer contributions, and adequate information about the nature of the scheme, the investment choices open to the member, and a risk statement regarding any circumstance that may prevent any benefit from being paid, or paid in full; and
- a contact point for enquiries and complaints.

We also would require that where any of the above changes in a material way before the member's benefits commence, he should be informed of the change. We recommend that DWP consult with the FSA to make this information consistent where appropriate with "key features" statements required under the personal pensions regime, or any successor FSA regulation.

125. Periodically we would expect the member who has DC benefits to be provided with a statement of the fund accrued in the scheme and the principal conditions attaching.

126. When the member leaves active membership of the scheme, and when benefits are about to become payable, the member (or survivor where appropriate) should be given adequate information within a reasonable time about:

- the amount, in monetary terms, of benefit for which the member and his or her family will qualify;

- any conditions to their qualification for benefits;
- the form that the benefit will take and any alternatives to that form (including transfer payments);
- a contact point (which must be kept up to date thereafter) for enquiries and complaints, and
- the process for appeal of the scheme's decisions.

127. On request the member should be given within a reasonable time :

- information regarding the cash equivalent transfer value of his or her benefits (if available);
- the amount of benefit available if pensionable service terminates;
- the amount of death benefit payable.

128. A member or a trade union recognised by the employer may request and receive free of charge within a reasonable time:

- a copy of the trust deed and rules;
- the most recent statement of investment principles;
- the most recent statement of funding principles and recovery plan;
- the annual report;
- the latest actuarial valuation;
- the payment schedule; and
- a copy of the winding up procedure plan.

Documentation that needs to be kept confidential for commercial reasons or to protect the privacy of members would be excluded from disclosure.

129. When a scheme commences winding up, the following information should be provided to members, and, where appropriate, survivors:

- information to the effect that the scheme is winding up (to be provided as promptly as practicable);
- a contact point for questions and complaints, to be updated regularly;
- progress reports at regular intervals;
- information of options available regarding transfer of benefit;
- where some members may not receive the full benefit set out in the rules, those members must be specifically informed of this situation as soon as practicable, and
- on wind up, a final statement of the benefits to which they are or will be entitled and the source from which those benefits will be paid.

130. Recommendation: A framework of outcome-related principles accompanied by guidance, should take the place of the existing disclosure regulations. The

guidance should set out some of the ways in which schemes could comply with the disclosure principles while making clear that the outcomes specified in the principles could be reached by other means. Schemes that comply with the existing legislation should be deemed to comply with the principles as long as their disclosure practice remains unchanged. If this approach to disclosure proves feasible and is considered an improvement on the current regime, the Government should consider other areas to which a principles based approach could be applied and establish a rolling programme.

PART III: SCHEME FUNDING AND ADMINISTRATION

A. Treatment of Surplus

131. Scheme sponsors are concerned that as schemes become more fully funded in response to international accounting standards, the risk-based levy and the demands of trustees in the course of transactions, resources that will never be needed for benefits will become trapped in pension funds. Currently, before the trustees can consider a return of funds to the employer, scheme funding must reach the level at which annuities can be purchased for all members from an insurance company. In order to approve a return, the statute provides that the trustees must be satisfied that it would be in the members' interests to do so.

132. We are told that, especially for large well-funded schemes, these requirements make little sense. An ongoing scheme should not be required to fund for any purpose as though it needed to pay the premium required by an insurance company to secure benefits. We are told that some believe that the requirement that trustees be satisfied that return would be in the members' interests imposes a duty beyond the trustees' normal fiduciary considerations. The opportunity to retrieve assets through contribution holidays diminishes for mature schemes, particularly those closed to new entrants. There is a legitimate concern that resources that might be better used investing in the business or to increase contributions to other pension arrangements for employees will languish in conservatively invested pension funds where they are not needed in the near term and may never be used.

133. We have been asked to consider two possible changes that would increase employer confidence that funds will not be trapped:

- automatic return to the employer at a premium above buyout level; or
- a lower threshold for return subject to trustee consent, at scheme specific funding level, or PPF funding level, for example.

134. We are disinclined to recommend automatic return, even at a very high level of funding, because excess funding can be attained in a variety of ways. Where the members have been asked to increase contributions or forego benefits, it would not be right to assume that the employer is entitled to a "return" of funds. Trustee input will be important to assure that the particular circumstances in which the so-called surplus arose are taken into account.

135. Similarly, we do not recommend allowing return of surplus at PPF level of funding – we do not believe that any legal test should be set to a PPF level of funding. The diminished benefits that would be provided by the government should the scheme fail should not be relevant. It is the benefits promised by the scheme, and the reasonable prospects of paying those benefits from the scheme that should inform the dialogue between trustees and employers.

136. However, we would favour changes to allow, although certainly we would not require, return of surplus over the scheme specific funding target where the employer requests it and the trustees agree. If the trustees believe that the scheme may soon be wound up, of course they should not agree to return funds, because they are not truly surplus to requirement. In that case, we would expect the scheme specific funding level to be set with probable buyout in mind. But we see no harm, and much good, in allowing the dialogue to begin in the context of establishing and reviewing the statement of funding principles. Trustees should have the ability to agree in principle, where appropriate, that once scheme funding targets are met, funds may be returned to the employer, provided the trustees remain satisfied at that time with the employer's covenant. This gives employers more

confidence that their contributions are not disappearing into a black hole from which they will never return, but allows an appropriate level of participation in funding decisions by trustees.

137. In order to facilitate this negotiation, we do not believe that the trustees should be explicitly tied in statute to being satisfied that any surplus return is in the members' interests. We have received evidence that an overly narrow and literal reading of this clause has led to difficulties between trustees and employers. We believe it is enough to rely on the trustees' underlying fiduciary duty.

138. We considered proposing safeguards for members to assure that "surplus" arising from benefit cuts and increased contributions by employees did not end up in the employer's hands. However, we decided that this is ultimately a matter for the trustees. The development of the scheme specific funding target and the statement of funding principles should take the probable future of the scheme, as well as the employer's ability to pay in the future, into consideration. After all, it is conceivable that it would be in the interest of the members to return funding held by the scheme to the employer even where benefit cuts had been made. In any case, complex regulations concerning what constitutes a benefit cut, how long after benefits had been cut a return could be contemplated, etc would not be consonant with either our deregulatory purpose or the reliance on trustees that we advocate for matters involving scheme funding.

139. It has been widely reported recently that scheme deficits have fallen, with some schemes even showing surpluses. This makes this recommendation all the more timely. It is, however, very difficult to draw out aggregate impacts of the proposals because these impacts are determined by behaviour at the scheme level.

140. Recommendation: The current provisions in section 37 of the Pensions Act 1995 should be amended to allow return of surplus to employers once the scheme has reached the scheme specific funding target and the trustees agree at that time that such a payment should be made. The existing explicit statutory requirement that the trustees must be satisfied that any surplus return is in the members' interests before giving their agreement should be repealed, on the grounds that it encourages overly conservative behaviour by trustees, who already have their fiduciary duties to observe.

B. Employer debt in multi-employer schemes

141. Many people consider that the current employer debt regulations are creating unacceptable difficulties. Over 40 stakeholders commented on this issue in response to our consultation, and almost all of the comment was negative. As we began our review, the DWP was undertaking a review of those regulations in response to similar complaints, and we have been in close contact with the Department concerning their progress.

142. At present, where an employer exits a multi-employer pension scheme, whether due to a sale, due to an internal reorganisation or because it no longer employs an active member, a “cessation event” is triggered and a debt arises unless the scheme is funded to a buyout level. The debt that the departing employer must pay is its “share of the difference” between the funding level of the scheme and the projected buyout level. The employer’s share is calculated (or at any rate supposed to be calculated) based on the past pensionable service of employees employed by that employer; so-called “orphan” debt arising from unattributed liabilities to members is then allocated based on the proportion of the ceding employer’s attributed debt.

143. We have been kept apprised of progress in the development of revised regulations on employer debt, and we have been encouraged by the discussions we have had with the Department. We have pushed for many of the technical complaints that we received from stakeholders to be addressed, as well as some complaints on the substance of the regulations. We have, for example, suggested that when an employer ceases to have employees actively participating in a scheme, the debt will not be triggered if, within a period of up to a year, the employer acquires more employees who participate in the scheme. This would alleviate many of the problems which have been experienced by small employers who employ only a few staff. We look forward to the publication of a consultation draft of the regulations.

144. In the meantime, we want to set out our general thinking on employer debt in the context of group reconstruction and the key principles which we think should underpin policy in this area. We believe that so long as the employer covenant remains good and the scheme has met its target funding level (or the terms of its recovery plan can be met), no debt should arise due to the departure of a participating employer in a multi-employer scheme of associated employers. Trustees should be required to insert themselves into discussions concerning corporate activity only when that activity endangers scheme funding at a prudent level. However, we part company over the terms that should apply where the employer covenant or scheme funding are already weak.

145. Chris Lewin believes that the proper focus of the trustees and ultimately TPR is on whether the employer covenant has materially weakened as a result of the departure of a participating employer from the group. If it has not, he would maintain that interference from either the trustees or TPR is unwarranted. An approach that requires monies to be paid over to the pension scheme and/or guarantees to be put in place could discourage a struggling company from measures, such as a sale or reorganisation, that could help put the business on firmer footing.

146. On the other hand, Ed Sweeney believes that where the continued ability of the employer to support the scheme at a prudent funding level is in doubt, it is appropriate that a debt arises on the exit of an employer from the scheme, whether or not there has been a change in the covenant. In those circumstances, trustees should be given the tools with which to assure that scheme funding will not suffer, and may in fact benefit, from the departure of that employer. He believes that this should be true even if the covenant cannot be shown to be materially weaker as a result of the departure of the employer.

147. Recommendation 1: Where a company that participates in a DB multi-employer scheme ceases to have employees actively participating in that scheme but the scheme continues, the debt should not be triggered if, within a period of up to one year, the employer acquires more employees who participate in the scheme.

148. Recommendation 2 - Where there is a group reconstruction of employers in a multi employer scheme, the principle should be established that the debt should not be triggered where the original covenant was strong, and if the remaining employers' covenant remains as strong, following the reconstruction, as the original covenant. The judgement as to whether the covenant remains intact should be the responsibility of the trustees, after taking appropriate professional advice. However, one of us (Chris Lewin) recommends that, where the original covenant is potentially weak, provided it remains unchanged after the reconstruction, the debt should still not be triggered.

C. Trustees

149. The need for confident and informed trustees who can work in partnership with employers to achieve the best results for scheme members has been a constant, recurring theme in our discussions with stakeholders and our conclusions here. If work-based pensions are to continue to be the basis of provision for older workers in the U.K., it is crucial that trustees do their jobs in a sophisticated and balanced manner, and that they be supported as they endeavour to do so.

150. TPR has done an excellent job of supporting and educating trustees regarding their duties and how to fulfil them, and most in the industry would agree that trustees generally are aware of and meeting their responsibilities to a much higher degree than has been the case in the past. Great strides are being made. However, we wonder whether the current legal environment is as supportive as it needs to be if non-professional trustees are going to continue to be the bedrock of scheme governance.

151. We start with the way in which trustee knowledge and understanding has been embedded in law and taken forward. Sections 247 - 249 Pensions Act 2004 requires that each individual trustee should have knowledge of the scheme documentation, including the deed and rules and the statements of funding and investment principles, as well as the law of occupational pensions, principles of funding and investment of assets. TPR reinforces this very explicit requirement for particularised knowledge through its code of practice and the trustee toolkit.

152. While we are enthusiastic about the toolkit and the important role it has in bringing trustees up to speed on the issues they are likely to face, we are, like many trustees, uneasy with the notion that each individual can or should be expected to make themselves knowledgeable in each of these areas. A board of trustees, like the board of a limited company, should function as a body.

153. Of course, each trustee must have a sufficient working familiarity with the basics of pensions finance and administration to ask intelligent questions and to take part in the decision-making process on an informed basis. However, we believe that trustees should be entitled to rely on the collective expertise of the group, as well as bespoke advice from professionals employed by the scheme, to a greater degree than now seems to be envisioned in the legislation and guidance. For example, senior managers who add value due to their in-depth knowledge of finance or management should not necessarily be expected to complete time-consuming training modules concerning the application of pensions law or the intricacies of scheme administration. Where a subcommittee is taking a particular decision, that subcommittee should have sufficient knowledge and understanding to take that decision, and the other members of the trustee board should be entitled to rely on their expertise. It may be appropriate to reconsider sections 247 – 249 Pensions Act 2004. The legislation should be amended so that it is the board as a whole who should be required to have sufficient knowledge and understanding between them to carry out their duties properly and the same should apply to any sub group to whom trustee functions are delegated.

154. We asked stakeholders whether the increased focus on trustees has made it more difficult to recruit and retain qualified trustees. The result was interesting - although there are many anecdotes to the effect that the increased emphasis on performance to a set standard has discouraged some individuals from seeking or retaining trustee positions, there does not appear to be much statistical evidence that the pool of qualified and willing trustees is shrinking. In its most recent governance survey, TPR finds that only a small

percentage of schemes reported difficulty retaining or recruiting trustees.²⁴ There can be no doubt, however, that the new environment has created legitimate concern. Indeed, in the same survey, over half the boards responding stated that risk and additional responsibilities carried by trustees is either a major or a minor issue to the board conducting its role effectively.

155. We have therefore given a good deal of thought to whether there are measures that we should recommend to support the men and women who take on this important role, often without pay. The clear trend is toward greater accountability from trustees of all varieties of trust and from directors of limited companies, as the recent Law Commission review of trustee exemption clauses²⁵ and recent changes to the treatment of directors under Companies Act 2006²⁶ show. We believe that as a quid pro quo for the increased visibility and controversy surrounding trustee duties, all pension scheme trustees should be covered, at employer or scheme expense, by appropriate indemnity insurance or assurances from the employer and/or the scheme, that would at least cover the cost of litigation so long as the trustee is not found to have acted improperly.

156. It is true that trustees who have acted in good faith are in large part protected because in the past only wilful negligence or misconduct has led to liability for breach of trust. However, there is some unease as to whether courts (or tribunals such as the Pensions Ombudsman) will continue to define breach of trust as narrowly as has been the case in the past, and even a trustee fully exonerated by a court or tribunal could be required to fund his defence, depending on the arrangement under scheme rules. Individuals who have appropriate cover may feel more free to take difficult decisions that they believe to be in the interests of the scheme, without fear that they are taking a personal financial risk if the decision turns out to have been less than optimal, however small that personal risk might be. Therefore, we think it appropriate that indemnity insurance for trustees be encouraged (except, of course, where indemnity would be forbidden by law²⁷) and that ongoing trustee expenses in the event of lawsuit be paid by the employer or out of the scheme unless a court or the tribunal orders otherwise.

157. We also received representations about enhancing trustee protection by more radical measures such as complete statutory exoneration or statutory indemnity from the scheme for trustees, provided they have acted in good faith. Chris Lewin believes that there is a strong case for a broad statutory indemnity (and that it would be worthwhile developing contingency plans for this), whereas Ed Sweeney disagrees, believing that such a response would be disproportionate, and could disrupt the balance between trustees' rights and responsibilities.

158. That said, we can certainly agree that the role of the trustee is critical to the continued health of occupational provision. Trustees need support and protection as they take on these important responsibilities. We strongly believe that the trust framework should continue to be the preferred method for providing pensions in the UK and that the interests of employers and members will be best served by boards that include volunteer trustees who take their responsibilities seriously. A properly functioning trustee board is the best tool/organisation for addressing and balancing the interests of the members and employers in the long term. In particular we believe that investment policy should continue to be the trustees' responsibility.

²⁴ See p 21, Occupational Pension Schemes Governance survey Report, July 2007.

²⁵ See The Law Commission (Law Com No 301) "Trustee Exemption clauses"

²⁶ See sections 232 – 235 Companies Act 2006

²⁷ Such as for civil fines and penalties (section 256 Pensions Act 2004) or for failure to take care or exercise skill in the performance of investment function (section 33 Pensions Act 1995)

159. Recommendation: The legislation should be amended so that individual trustees or trustee-directors are not required to have particular standards of knowledge or understanding on a range of issues. Instead each trustee board should be required to ensure that the board as a whole have sufficient knowledge and understanding between them to carry out their duties properly. The same should apply to any subgroup to whom trustee functions are delegated. In addition, we recommend that by overriding legislation a rule be inserted in all schemes that reasonable personal legal expenses of trustees that arise from the performance of their duties will be promptly reimbursed by the scheme, subject to the power of a court or tribunal to order that such reimbursement should be refunded to the scheme later.

FRS 17

160. As we said in our consultation paper, the Accounting Standards Board (ASB) is currently reviewing the financial reporting of pensions and is expecting to issue a discussion paper later this year. The International Accounting Standards Board (IASB) has also taken on a pensions project that could lead to revised international accounting standards. Whilst the operation of FRS17, and in particular its volatility as a measure, has arguably had an adverse impact on scheme investment choice and employer behaviour, it is outside our remit to suggest changes in this area. We have therefore asked the DWP to pass on the feedback received to the ASB so that it can be taken into consideration as part of their review.

Miscellaneous issues

161. In the consultation document we published in March, we included, as an annex, a list of technical areas that had been raised with us by stakeholders as potentially needing change or clarification, but which we had not had time to consider properly. We have now had the opportunity to pursue these with the DWP, and are satisfied that in most cases, either progress is being made or there are good policy reasons for retaining the status quo. We have dealt in more detail with the significant number of detailed issues raised on employer debt earlier in our report.

162. In addition to those, we would also single out several other areas as worthy of specific comment. We received a number of representations on the administrative difficulties caused by the restrictions on protected rights. We are reassured that the Department is well aware of these issues. The current Pensions Bill includes provision to remove the rules which apply to protected rights, with the exception of the rule which requires a member to provide for a survivor's benefit, if they are married or a civil partner at the time of annuity purchase. The joint DWP/Treasury review of the Open Market Option is currently reviewing the question of survivors' benefits and is due to report towards the end of the year.

163. The second area is safeguarded rights and more generally the complex area of pensions sharing on divorce. Here we have been encouraged by the willingness of the DWP to contemplate change, and we recommend that the policy and legislation on pensions sharing on divorce should be reviewed with a view to making significant simplifications to the provisions.

164. Another area is the requirement for cash transfer sums from money purchase schemes to be guaranteed for a period of time and where no allowance is made for the changing value of investments. We are pleased that DWP has taken concerns about this on board. The draft Occupational Pension Schemes (Transfer Values) (Amendment) Regulations 2007, which were issued for consultation in early July, make provision for a cash transfer sum of money purchase benefits to be increased or decreased to reflect the amount at the date the investments are surrendered.

165. Finally, we wish to discuss briefly the issue of making it allowable, once more, for employers to make membership of their scheme a condition of employment. This was not included in our consultation report, but became an issue during the consultation period itself. We were both initially very attracted to this proposal for a number of reasons: it provided simplicity, a potentially solid foundation for risk sharing arrangements, and, despite the now rather old-fashioned paternalistic overtones, was one of the key reasons for the wide coverage achieved by occupational pensions in the 60s, 70s and 80s. A number of people said to us during the consultation period that the best thing their employer ever did for them was to insist on them joining the occupational pension scheme. However, we have come to accept, with regret, that this idea's time has passed. Furthermore we have received advice that there are potential issues under the Human Rights Act, and that there is a risk of a two tier application, whereby existing employees would have to be offered an opt-out. Finally, there is the practical difficulty of matching such a policy with that being developed for personal accounts, and so we have decided not to pursue this idea.

**Organisations & individuals that responded to the consultation
(some submitted more than one response)**

A S Wallace
Abacus Lighting Limited
Actuarial Profession
Adrian De Segundo
AEGON
Alan Smallbone
Alliance for Finance
Amicus
Anthony R Price
Anton Jeary
Association of British Airways Pensioners
Association of British Insurers
Association of Consulting Actuaries
Association of Member-Directed Pension Schemes
Association of Pension Lawyers
AXA-Sunlife
Baker & McKenzie
Balfour Beatty
Barclays
BECTU
Board of the Pension Protection Fund
BP
British Air Line Pilot's Association
CBI
Civil Aviation Authority Retired Staff Association
Committee of Unilever Pensioners
Connect union
Co-operative Group Pensions Department
David Evans
Derek Benstead
Electricity Pensions Services Limited
Fidelity International
First Actuarial PLC
Foster Wheeler Pensioners Association
Freshfields Bruckhaus Deringer
George & Harding Construction Ltd
GMB
HSBC
Hundred Group
ICI Pensions Trustee Limited
Inchcape PLC
Independent Television Commission Retirement Association
Institute of Chartered Accountants
Investment Management Association
Jardine Lloyd Thompson
Joel Kosminsky
John Grannells
Kenneth Stephen Molloy
Legal & General
Mark Bondi
Martin G Whapshott

Mayer, Brown, Rowe & Maw
Mercer Human Resource Consulting
National Association of Pension Funds
NTL Pension Association
Occupational Pensioners' Alliance
Peter D Beattie
Pensions Advisory Service
Pensions Management Institute
Pensions Research Accountants Group
Pete Davis
PricewaterhouseCoopers
Prudential
Punter Southall
Rackhams Body Shop
Railways Pension Scheme
Royal Ordnance Pensioners' Association
Society of Pension Consultants
Stephen Treharne
Standard Life
Tesco
Towers Perrin
Trustee Risk Management Advisory Service
TUC
UNITE
Watson Wyatt