Guide to the Pensions Act 2004

Department for Work and Pensions

Ministerial foreword

This Pensions Act 2004 is a landmark in securing and strengthening the UK's tradition of private pension provision and a major stepping stone on the road to meeting the demographic challenges posed by an ever healthier, but increasingly ageing, population.

The Act creates the Pension Protection Fund, a major new institution that radically transforms the nature of protection offered to members of defined benefit pension schemes. It means that over 10 million members of final salary pension schemes can benefit from the security and peace of mind that they will receive a meaningful occupational pension, even if their company becomes insolvent and leaves the pension scheme underfunded.

Additionally, the new Pensions Regulator will assist in protecting members' benefits, while the Financial Assistance Scheme will provide help to some of those who have lost out before the Pension Protection Fund is established.

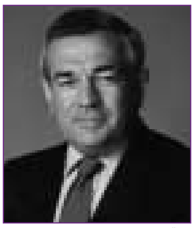
These protection measures are crucial in bolstering confidence in pensions and go hand in hand with measures in the Act that help employers to provide pensions in the first place.

We have taken action to help schemes strip away layers of regulation that have built up over the years, and the new Pensions Regulator will adopt a light-touch approach where possible. The removal of the limited price indexation cap for defined contribution schemes is a major simplification, while its reduction for defined benefit schemes will help to reduce the costs of occupational pension provision. This complements the radical tax simplification in this year's Finance Act, which from April 2006 will replace today's eight separate tax regimes with one single regime.

The third key dimension of the Act is the set of measures that will empower people to plan, work and save for their retirement. This includes the introduction of an enhanced pension or a lump sum of, on average, £20,000 to £30,000 for people who choose to delay taking their State Pension for five years. Complemented by separate forthcoming age discrimination legislation, it means that people will have greater opportunity and greater rewards from choosing to work for longer – without being forced to do so.

We hope you will find this guide helpful. It sets out in more detail the measures in this Act that strengthen protection, seek to make it easier for companies to run schemes and enable individuals to plan, work and save for their retirement.

Rt Hon Alan Johnson MP
Secretary of State for Work and Pensions
November 2004



Malcolm Wicks
Minister of State for Work and Pensions

Building confidence in pensions

The Pension Protection Fund

The Act establishes the Board of the Pension Protection Fund, which will be a new non-departmental public body. In essence, the Board of the Pension Protection Fund will protect members of certain defined benefit schemes and hybrid schemes by paying compensation if their employer becomes insolvent and the pension scheme is sufficiently underfunded. It will be introduced from April 2005.

Where the Board of the Pension Protection Fund assumes responsibility for a scheme, it will pay compensation to the members of that scheme and in certain circumstances to their survivors. The amount of compensation is linked to the scheme rules relating to calculation of an individual's pension. The amount of compensation paid to some people will be subject to a cap. Some annual increases will be made to compensation payments.

The Pension Protection Fund will be funded through charging compulsory levies on the trustees and managers of defined benefit schemes and hybrid schemes. The pension protection levies will consist of a scheme-based and a risk-related pension protection levy. The risk-related element will ultimately account for at least 80 per cent of the total amount raised. This will mean that costs will be kept down for employers with well-funded schemes. When assuming responsibility for a scheme, the Board of the Pension Protection Fund will also take in the remaining assets of the scheme to help pay towards any compensation. An administration levy will also be imposed to meet the Board's administrative costs.

The Board of the Pension Protection Fund will comprise of a Chairman, a Chief Executive and a minimum of five other members. In line with good corporate governance guidelines, it will have a majority of non-executive members.

The Board will take over the functions of the existing Pensions Compensation Board later in 2005 and will continue to pay compensation to both defined benefit and defined contribution occupational pension schemes in cases of fraud and misappropriation of scheme assets.

The Board's main functions will include paying pension compensation, managing the calculation and application of the levies, setting and overseeing the investment strategy and paying fraud compensation.

The Pensions Regulator

The Act provides for a new Pensions Regulator to replace the Occupational Pensions Regulatory Authority (Opra) in April 2005.

The Regulator's statutory objectives and functions set out in the Act establish a clear framework for its regulatory activity. It will inherit Opra's existing powers and will, in addition, have a number of new ones, including:

- a power to issue improvement notices compelling schemes to take or refrain from taking specified action where pensions legislation has been contravened;
- the ability to freeze a scheme while Regulator investigations take place;
- increased powers to suspend, prohibit and remove trustees;
- imposing a statutory obligation on certain persons involved with a scheme to report suspected breaches of the legislation to the Regulator;
- measures to combat pensions liberation to ensure that liberated funds are repatriated to a member's pension scheme where possible;
- powers to issue contribution notices and financial support directions; and
- increased powers to gather information to enable the Regulator to identify and focus on the schemes most likely to present a risk to scheme members' benefits.

The Regulator will be able to provide education, assistance and information to those administering or advising on pension schemes. It will also issue Codes of Practice to enable scheme trustees and professionals to understand the legislative requirements.

The Financial Assistance Scheme

The Act allows for the setting up of a Financial Assistance Scheme to help some people who have lost out on their defined benefit occupational pension because their pension scheme has been wound up underfunded and the employer has been unable to make up the deficit.

£400 million of public money over 20 years has been committed to the Financial Assistance Scheme. Details, including who will be eligible and the level of assistance to be provided, are being developed in consultation with stakeholders such as pension scheme members, trustees, trade unions and key business representatives.

For further information and to register for a free email update service on the development of the Financial Assistance Scheme, please log on to **www.dwp.gov.uk/fas**

Preferential liabilities and deficiencies in scheme assets on winding up

The Act makes changes to legislation in the Pensions Act 1995 that will protect members of defined benefit occupational pension schemes if their scheme is winding up. It is intended that this will apply to schemes which start winding up from April 2005 when the Pension Protection Fund legislation comes into force.

The Act provides for a new statutory priority order that will continue to apply whether a scheme starts to wind up because of insolvency of the employer or while the employer is solvent.

The Act changes the legislation on the debt that can be owed by an employer to a scheme if that scheme is underfunded and either it is winding up or the employer becomes insolvent. The changes have been made so that this protection measure works in conjunction with legislation on the Pension Protection Fund.

Requirement for member-nominated trustees and directors

The Act provides for at least a third of trustees in every scheme to be nominated and selected by a process involving members – and provides a power for the minimum proportion to be half at some stage in the future.

Obligations of trustees of occupational pension schemes

The Act amends current legislation on scheme investments to allow for regulations to be made to ensure compliance with the EU Occupational Pensions Directive that comes into force in September 2005.

The Act requires trustees to be conversant with relevant scheme documentation, and have appropriate knowledge and understanding of pensions and trust law and of the principles underpinning investment and funding. It imposes the same requirements on individuals exercising trustee functions on behalf of a corporate trustee. The Regulator will issue a Code of Practice to give practical guidance on the sort of knowledge required. The aim is to ensure that trustees are competent in carrying out their duties.

Following the removal (by the Finance Act 2004) of the requirement on occupational schemes to run down excessive actuarial surpluses in order to keep tax advantages, the Pensions Act modifies existing restrictions on payment to the employer from such surpluses. It is proposed that regulations will specify that such payments can be made only where sufficient funds remain in the scheme to cover the accrued rights of all beneficiaries.

Consultation by employers

The Act will place a statutory obligation on employers to consult prospective and affected active members of pension schemes before making major or significant changes in respect of future pension arrangements. These employees and/or their representatives will have a process to feed in their views about proposed changes to their employer for consideration before a decision is made by the employer about future pension arrangements.

Pension protection on transfer of employment

Where employees already have, or would have, access to an occupational pension, they should not lose out just because of a company takeover. Where a transferor employer contributes to an occupational pension scheme, employees will have the right to ongoing employer pension provision from the transferee if there is a business transfer that is covered by the Transfer of Undertakings (Protection on Employment) (TUPE) Regulations. Transferee employers must offer the transferred employee membership of a defined benefit pension scheme that meets a prescribed standard, a defined contribution pension scheme, or a stakeholder pension scheme. Where the scheme offered is a defined contribution or stakeholder arrangement, the transferee employer must match the employee's contributions up to a prescribed level (to be set at 6 per cent).

The provision offered will form part of the employee's contract of employment with the transferee employer and can only be changed following agreement by both parties.

Making it easier to run schemes

Scheme funding

The Act sets out provisions that provide for the replacement of the current standardised Minimum Funding Requirement with new scheme funding requirements. These provisions will apply to most private sector defined benefit schemes. They will replace the one-size fits all approach of the Minimum Funding Requirement with a requirement to meet a new statutory funding objective. Within this framework, which complies with the EU Occupational Pensions Directive, schemes will have more flexibility to take into account scheme-specific factors (such as the scheme's investment policy, the age profile of members, staff turnover and likely future salary increases) when determining the most appropriate funding strategy for their particular scheme. Greater scope should exist for taking a longer-term view of investment and for realising funding efficiencies.

This does not remove the obligation for schemes to obtain actuarial valuations at least once every three years. Where it appears from a valuation that the statutory funding objective has not been met, schemes will be required to put a recovery plan in place that will set out the period over which the statutory funding objective will be met.

These new provisions require trustees and employers to work in partnership on the scheme's funding strategy, to take advice from the scheme's actuary, and to set this strategy out in a statement of funding principles. Where trustees and employers cannot agree the amount required to meet the statutory funding objective, the statement of funding principles, the recovery plan or the schedule of contributions, the new Pensions Regulator has been given powers of last resort to help resolve matters. The Act also requires the Regulator to issue a code of practice for trustees on scheme funding.

The Pensions Regulator

The Regulator will have more extensive powers to collect relevant information and to have breaches of the law and specific events notified to it. It will use this information to assess the risk to scheme members' benefits, providing a more effective early warning of problems within a scheme. This system will lead to proportionate regulation that rewards schemes that are well run by reducing the regulatory burden.

Modification of pension rights

The Act enables schemes to make changes to their rules modifying members' accrued pension rights, provided certain requirements are met (for example, certain changes are prohibited unless the member gives his or her consent, the actuarial value of accrued rights must be maintained, and the trustees must approve a change). This will give schemes greater flexibility to rationalise their arrangements, to adapt to changing circumstances and to reduce administrative costs and complexity, while providing appropriate protection to members' interests.

Annual increases in the rate of pensions

To reduce the burden on defined benefit pension schemes, the Act provides for the limited price indexation cap to reduce from 5 per cent to 2.5 per cent. The measure will help balance the costs that will arise from the levy imposed by the Pension Protection Fund. The change affects pension rights accrued on or after the commencement date (planned for 6 April 2005).

The Act also removes the requirement to provide limited price indexation to pensions paid from defined contribution schemes which come into payment on or after 6 April 2005. This represents an increased choice for scheme members and provides an important administrative simplification for schemes. Regulations covering the pre-6 April 1997 indexation will be amended to ensure that indexation is removed completely for defined contribution benefits. The Government is aiming for this measure to come into effect from 6 April 2005 and the change will affect pensions coming into payment on or after that date. The Government is also proposing to ensure that members of defined contribution schemes receive the information they need to help them decide whether or not they want to opt for an annuity that also provides limited price indexation.

Contracting out

The Act removes some of the restrictions that currently apply to contracted-out rights in occupational defined contribution schemes and personal pension schemes that have opted out of the additional State Pension. The provisions remove the minimum age in the Pension Schemes Act 1993 from which protected rights can be paid, enabling them to be paid at the same time as all other rights. This will ease schemes' administrative burden in handling these rights and represents a significant simplification of the contracting-out regime.

Internal dispute resolution

Existing legislation on the requirement for schemes to provide a procedure for dealing with disputes has been criticised for being too rigid and prescriptive. The Act replaces this with new requirements that are much simpler, require only a one-stage process, and will allow schemes to adopt procedures that are best suited to the way they operate.

Cross-border activities within the European Union

The Act sets out conditions that must be fulfilled before an occupational pension scheme established in the UK may accept contributions from employers located in other EU Member States, in accordance with the provisions of the EU Occupational Pensions Directive. The Act also provides the framework within which an employer located in the UK may pay contributions to an occupational pension scheme established in another EU Member State.

Late payments by employers

Where an employer makes payments to an occupational or personal pension scheme, the payments have to be made by certain deadlines. The Act puts in place new arrangements that do not change those deadlines but provide greater flexibility with regard to reporting arrangements. Trustees and managers of pension schemes will only have to report a late payment where it is of material significance to the Regulator. A Code of Practice will set out what the Regulator considers to be of material significance.

Helping people plan, work and save for retirement

State Pensions

The Act puts in place measures which mean that people will have a choice of reward if they put off claiming their State Pension for at least 12 months from April 2005. This can be an increase in the weekly pension (when finally claimed) of around 10.4 per cent for every full year of deferral or a one-off taxable lump-sum payment based on pension foregone plus an annual rate of return (2 per cent above Bank of England base rates) instead of an increase in the weekly pension.

In addition, the Act brings forward the date from which the increased rate of weekly pension for deferrers will be applicable from 2010 to 2005 and removes the five-year limit on how long a person may defer to earn extra State Pension.

For example, someone who delayed claiming a State Pension of £105 a week for five years from April 2005 could increase their pension to £159 a week for life or, instead of the extra £54 a week, get a lump sum of around £32,000 before tax (figures based on 2004/05 rates).

The extra State Pension will be treated in the same way as any other retirement income in calculating Pension Credit. And it may result in earning additional savings credit where the person's income exceeds the threshold currently set at the level of basic State Pension.

Lump-sum payments will be fully disregarded in calculating Pension Credit, Housing Benefit and Council Tax Benefit for pensioners.

The Act also, in two areas, serves to put payments that had previously been made on an extra-statutory basis on a statutory footing. It restores the policy intention that enables a person to choose between more than one State Pension that they are entitled to when the pensions are of the same category. It also ensures that a person now permanently living in the UK, who had a defined period of residence in Australia that was affected by the termination of the Social Security Agreement between the UK and Australia, can continue to have this period treated as if they had lived in the UK and had paid voluntary Class 3 National Insurance contributions. This helps a person's entitlement to a UK basic State Pension, Widow's Benefits or Bereavement Benefits if they subsequently make a claim to them.

Planning for retirement

The Act contains measures to take forward the wider Informed Choice agenda set out in the February 2004 Command Paper *Simplicity, security and choice: Informed choices for working and saving*.

The Act contains reserve powers that could require certain employers to provide their employees with access to pension information and advice (the results of a pilot study, currently being undertaken, will inform how the new power will be used). Another reserve power could require the trustees and managers of private or occupational pension schemes to issue Combined Pension Forecasts.

The Act also enables the development of a new web-based retirement planner, which will help users to access a range of non-governmental sources of information and advice. The planner, due to be launched in April 2006, will enable people to calculate an approximate forecast of their current projected income in retirement from state and private pension provision, estimate the income they might actually need in retirement and consider the choices available to make up any shortfall. The planner will also assist individuals in tracing any 'lost' pension entitlements from previous periods of employment.

Early leavers

New rights will be introduced for employees who leave occupational pension schemes after a short period of time (this is particularly relevant to women, who are more likely to interrupt their working lives for caring responsibilities and who have lower occupational pension rights over their working lives).

In some schemes, people have to be a member for at least two years to be entitled to vested pension benefits. (This is called a vesting period.) From April 2006, a new provision will apply to employees who leave after three months but before the end of a vesting period. Trustees will have to offer these early leavers the choice of a cash transfer sum to take to another scheme willing to receive the transfer, or a refund of their employee contributions. The option of a cash transfer sum means that, for the first time, this group of early leavers will be able to benefit from the value of their employer's contributions as well as their own.

Treatment of occupational pension rights during adoption and paternity leave

The Act introduces important new measures that are intended to safeguard the pension rights of employees taking adoption and paternity leave. Employers will be required to treat periods of paid paternity and adoption leave in the same way as periods of normal work for the purposes of employment-related pension schemes. This brings the provisions for paid paternity and adoption leave into line with the provisions for paid maternity leave.

Full details of the Pensions Act 2004 are available from HMSO at **www.hmso.gov.uk**

For more copies of this leaflet call **0845 7 31 32 33** (textphone 0845 604 0210). Or you can write to Pension Guide, NAT 5951, Ashby de la Zouch, LE55 7QP (you don't need a stamp).

You can also see this guide on our website at **www.dwp.gov.uk** This guide is available in Welsh, on audiotape and in Braille.

ISBN 1-84388-390-2