Deregulatory Review of Private Pensions

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The Pensions Commission identified a "rapid decline in private sector Defined Benefit (DB) provision (primarily final salary in form)" over the last 10 years. A contributory factor to this, it said, was that there had initially been a high degree of discretion in employer pension promises. Over time, legislation had removed this discretion, adding to the cost of pension provision. Other factors, such as increasing life expectancy, were also important.

With the aim of supporting existing occupational pension provision, the Government has established a rolling deregulatory review of private pension regulation. In December 2006, Chris Lewin (formerly Head of UK pensions at Unilever) and Ed Sweeney (then joint Deputy General Secretary of Amicus) were appointed as external reviewers. They issued a consultation paper in March 2007 and a report to DWP in July 2007.

The Government agreed with the reviewers that it would not be appropriate to make changes that would affect accrued rights. It also decided not to remove the statutory requirement to increase pensions in payment (Limited Price Indexation). Changes which have been implemented include:

- A reduction in the cap on the required revaluation of deferred pensions, from 5% to 2.5% for future accruals;
- A limited 'statutory override' to allow schemes to change rules, where trustees agree, to reflect lower revaluation and indexation caps;
- Measures to simplify the treatment of "pension credits" where a pension has been shared on divorce.

A number of other issues are under consideration, including regulations on "employer debt" and disclosure of information.

This note looks at the background to the Deregulatory Review, its recommendations and the policy changes that have been made. A separate note, SN/BT/1759 Defined Benefit pension schemes looks at recent trends and policy initiatives more broadly.

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1 Background

1.1 Trends in Defined Benefit (DB) schemes

The Pensions Commission identified what it described as “rapid decline in private sector DB provision (primarily final salary in form)” over the last 10 years.[1] It found it “difficult to see private sector DB provision, certainly final salary in form, playing more than a minimal role in the future UK pension system”.[2] In its second report, published in November 2005, it provided a useful analysis of the trends. It concluded that:

> The exceptional equity returns in the 1980s and 1990s allowed man private sector schemes to ignore the rapid rise in the underlying cost of their pension promises. When the fool’s paradise came to an end, companies adjusted rapidly, closing DB schemes to new members.
>
> A reduction in the generosity of the DB pension promises which existed by the mid-1990s was inevitable. That generosity had not resulted from a consciously planned employer approach to labour and market competition, and would never have resulted from voluntary employer action well informed by foresight as to the eventual cost, or operating within rational expectations of equity market returns.
>
> But the suddenness of the delayed adjustment, and its extremely unequal impact between existing and new members, have severely exacerbated the gaps that always existed in the UK’s pension system.[3]

The Pensions Commission said one of the key points arising from its analysis of trends in DB schemes was the fact that there had initially been a high degree of discretion in employer pension promises. However, over time legislation had removed this discretion, adding to the cost of pension provision. Other factors, such as increasing life expectancy, were also important contributory factors:

- Many of the reasons for the growth of private sector occupational provision in the UK were specific to the economic and social policy context of the 1950s to 1970s.

- These pension promises were also put in place in the period when longevity trends were not well understood, with decisions based on expectations of life expectancy which turned out to be far too low.

- The original promises were subject to a high degree of discretion, and were only affordable at the originally estimated cost precisely because of that discretion. In particular they treated early leavers badly and often increased pensions in payment less than in line with inflation. But this discretion was removed by legislation during the 1970s, 1980s and 1990s as government, slowly retreating from its role in pension provision, aimed to place more of the burden of adequate pension provision on the voluntary occupational system.[4]

The Commission said changes in regulation and context had increased DB scheme costs:

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1 Pensions Commission, Second Report: A New Pension Settlement for the Twenty-First Century, p123
2 Ibid, p48
3 Ibid, p123
4 Ibid, p124

> The combined effect of these changes in regulation and context was that the underlying cost of a typical final salary pension promise as a percentage of salary rose from 10-14% when most schemes were initially designed, to 22-26% today.[5]

The Government's says there is no doubt that regulation has contributed to a belief by some employers that the costs and risks of pension schemes are becoming too great:

> The present regulatory system governing occupational pensions has grown incrementally over the course of the past thirty years. It is now, by common consent, lengthy, complicated and hard to understand. Although each successive layer usually had the aim of protecting scheme members or simplifying the regulatory structure, there have been unintended consequences, leading to undesirable outcomes. Whilst by no means wholly attributable to the growth of regulatory burdens, there is little doubt that the weight of regulation has contributed to a belief by some employers that the costs and risks of having their own pension schemes are becoming too great.[6]

The Pensions Policy Institute found that a number of factors had influenced the decline in DB schemes, including better than expected improvements in longevity, low investment returns, increased legislation and regulation, and broader economic factors. The actual cost of increased regulation was difficult to measure:

> Recently the Deregulatory Review stated that the ever-increasing regulatory burden surrounding DB schemes was one of several important reasons for the flight from DB. Legislative changes can also have the additional impact of increasing scheme administration costs. 74% of a sample of employers running small DB schemes said they were very concerned about the increasing burden of management time running schemes, and 71% about the impact of legislation on benefits and funding costs.
>
> There is a perception that increased regulation has resulted in higher costs for employers. In reality, it is difficult to measure what impact the new rules have had on the cost of running DB schemes. Scheme sponsors report concerns about increased regulation but it is difficult to prove that the regulations have directly influenced employer behaviour. And one must also consider what the counterfactual would be. Part of the policy rationale of the increase in regulation, and the added security it has brought, may have played a role in supporting consumer confidence in pensions. But once again this is difficult to measure.[7]

It argued was no guarantee that allowing pension schemes increased flexibility would stem the flow away from DB:

> Changes to the law could increase this flexibility further by giving schemes discretion over the rate of pension increases before and/or after retirement or by making it easier for schemes to change their rules in relation to promises already made. But there is no guarantee that this will be sufficient to stem the flow away from DB. Despite the flexibility that already exists, many sponsors have chosen to drop DB schemes altogether in favour of DC arrangements.[8]

Nicholas Hillman argued, in a report for Policy Exchange, that DB provision needed to be made more affordable:

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5 Ibid, p123

6 DWP, Deregulatory review – Government response, October 2007, p35, para 3

7 PPI, The changing landscape for private sector Defined Benefit pension schemes, October 2007, p27

8 Ibid, p49

If defined benefit provision is to survive, it needs to become more affordable. In particular, there should be:

- more flexibility for schemes wishing to respond to changes such as rising longevity;
- a new regulatory regime for risk-sharing schemes; and
- closer alignment of the benefits available from public sector and private sector schemes.[9]

1.2 Previous reviews of pensions regulation

The authors of the current Deregulatory Review say they have drawn on the work of previous reviewers of the regulatory framework and in particular those of Professor Goode in 1993 and Alan Pickering in 2002.[10]

In 1992, the Pension Law Review Committee, chaired by Professor Roy Goode, conducted a review of "the framework of law and regulation within which occupational pension schemes operate."[11] This was followed by the *Pensions Act 1995* which introduced, among other things, the minimum funding requirement, the requirement to index-link pensions in payment and measures to protect accrued rights (section 67). The background to this is covered in Library Research Paper 95/46, The Pensions Bill [HL]: Pension Fund Regulation.

In 2002, Alan Pickering was commissioned to "carry out a comprehensive review of DWP private pensions legislation to identify a package of options for simplification and the reduction of compliance costs."[12] His report was published on 11 July 2002. Amongst other things this recommended more flexibility to modify schemes; and the ending of compulsory indexation for defined benefit pensions, and compulsory survivors benefits.[13] The subsequent *Pensions Act 2004* introduced a number of changes. For example, it:

- reduced the cap on the statutory requirement for private sector defined benefit pension schemes to index pensions in payment, from 5% to 2.5%, from April 2005;[14]

- allowed pension schemes to make 'detrimental modifications' affecting accrued rights, provided they do so with the informed consent of affected members or on the basis of actuarial equivalence.[15]

The background to this is covered in more detail in Library research paper 04/18, the *Pensions Bill 2003-04* and in Library standard note SNBT/3046, the *Pensions Bill 2003-04: amendments in Parliament.*

2 The Deregulatory Review of Private Pensions

The Government is in the process of reforming the pension system. The *Pensions Act 2007* legislated for reform of the state pension system. Among other things, it changed the contribution conditions to make it easier to qualify for a full state pension and will introduce a

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9 Nicholas Hillman, Quelling the Pensions Storm, 2008

10 Lewin and Sweeney, Deregulatory Review of Private Pensions. A Consultation Paper, March 2007, p5

11 Pension Law Reform, The Report of the Pension Law Review Committee, Volume 1, piii

12 DWP press notice "Simplifying Pensions legislation" 26 September 2001

13 Alan Pickering, *A simpler way to better pensions*, July 2002, Executive Summary

14 s278, the *Pensions Act 2004*

15 s262, *Pensions Act 2004*

phased increase in the State Pension age. There were also some changes to occupational and personal pensions: allowing DB schemes to convert Guaranteed Minimum Pensions to scheme benefits on the basis of actuarial equivalence from April 2009; and abolishing contracting out for Defined Contribution (DC) schemes, probably from 2012.[16] More details can be found in Library research paper 07/05, The *Pensions Bill 2006-07* and in Library standard note SNBT/4295, *Pensions Bill 2006-07 – debates in Parliament.*

In its May 2006 Pensions White Paper the Government announced its intention to establish a new system of personal accounts, probably from 2012, to give those without access to occupational pension schemes the opportunity to save.[17] Alongside this, the Government has said it considered it necessary to:

> support work-based pension provision and protect scheme members with a regulatory regime that encourages employers to continue to play a prominent role in pension provision.[18]

With this in mind, it established of a rolling deregulatory review of pensions regulation. The White Paper said:

> 2.42 In addition, we are now launching a rolling deregulatory review of pensions regulation, which will feed into DWP's simplification plan, to be published later this year. It may be possible to remove, merge or simplify many of the layers of legal requirements introduced in and since the 1995 Pensions Act. This could include re-examining the provisions on matters such as:
>
> - mandatory indexation of pensions in payment;
> - member-nominated trustees;
> - administrative and internal control requirements;
> - restrictions on changes to accrued rights (section 67);
> - payments to employers where surplus funds exist;
> - deemed buy-back; and
> - internal dispute resolution.[19]

In December 2006, two external reviewers Ed Sweeney (then joint Deputy General Secretary of Amicus) and Chris Lewin (formerly Head of UK Pensions at Unilever) were appointed. They were to work with an Advisory Group which included representatives from the industry, employer representatives, trade unions and statutory bodies, such as the Pension Protection Fund and Pensions Regulator.[20] Their terms of reference were to

> 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.

16 Sections 14 and 15, the *Pensions Act 2007*

17 DWP, *Security in retirement: towards a new pensions system*, Cm 6841, May 2006, para 2.3

18 Ibid, para 2.3

19 Ibid, para 2.41

20 DWP website/pension reform/advisory group

> The review will ensure that emerging proposals are based on robust analysis and are coherent. The external reviewers will work with the established advisory group to produce an initial report to Ministers by spring 2007.[21]

The external reviewers published a consultation document, *Deregulatory Review of Private Pensions. A Consultation Paper* on 9 March 2007. Their report *Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions,* was published on 25 July 2007. The reviewers argued that one of the most important reasons for the flight from DB schemes in recent years had been the regulatory burden:

> 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.[22]

To address this, they placed the emphasis in their 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.[23]

They did not think accrued rights should be affected:

> 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.

They argued that, taken as a whole, their recommendations would make a significant difference to the regulatory scene:

> 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

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21 Lewin and Sweeney, Deregulatory Review of Private Pensions. A Consultation Paper, March 2007
22 Ibid, Foreword
23 Ibid

> 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.[24]

The *Financial Times* reported the National Association of Pension Funds (NAPF) as saying it was unclear whether the proposals would be enough to halt closures of DB schemes.[25]

2.1 The Government's response

The Government's response to the independent reviewers' report was published on 22 October.[26] The Government emphasised that this was a complex area, in which it is "difficult to strike the right balance between removing legislative burdens and protecting members." It did not believe that there was "a single measure or even a series of measures which would guarantee that employers would continue to provide and even strengthen their existing pension provision."[27] The aim of its proposals was:

> a broadly beneficial impact on the cost-benefit balance of running an occupational pension, and the Government hopes they will be welcomed as such by employers, trustee boards and scheme members. It hopes that they will have some influence on decisions yet to be taken on whether or not to keep defined benefit pension schemes open.[28]

Decisions on some key issues were announced:

- The Government agreed with the reviewers that "it would not be appropriate to make changes which would affect rights which have already accrued."[29]
- It decided not to remove the statutory requirement to increase pensions in payment (Limited Price Indexation).

It would seek further views on:

- The proposal to reduce the cap on revaluation of deferred pension benefits accrued from a future date, from 5% to 2.5%.
- The proposal to introduce a statutory override to enable schemes to amend their rules to reflect the reduction of the cap on Limited Price Indexation from 5% to 2.5% which came into effect on 6 April 2005, and any change to the cap on revaluation.
- Whether it would be appropriate to introduce a third layer of legislation to make provision for a particular type of risk-sharing scheme.

In addition, the Government was to:

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24 Ibid
25 'Review snubs pension costs reforms', *Financial Times*, 26 July 2007
26 DWP, *Deregulatory review – Government response*, October 2007
27 Ibid, Executive Summary
28 Ibid
29 Ibid

- carry out further work to seek a practical solution to the difficulties encountered in relation to the application of the employer debt provisions where there is a group reconstruction in a multi employer scheme;

- explore with stakeholders, over the coming months, the scope to address concerns about the legislative requirements which must be met before surplus funds can be returned to the employer;

- move towards a principles based approach to legislation with the disclosure requirements relating to the day to day running of a pension scheme being used as a test bed for that approach;

- repeal the legislative requirements on pension sharing which apply to safeguarded rights and review the remaining legislation applying to the payment of pension credit benefits (i.e. those benefits which arise from pension sharing, not state pension credit);

- move to combat misconceptions about the trustee knowledge and understanding requirements by clarifying the effect of the relevant legislation.[30]

The Government's response to the consultation on the questions it posed in October was published on 5 December 2007. The *Pensions Bill 2007-08,* published on the same day, contained provision to:

- reduce the cap applying to the revaluation of deferred pension rights from 5% to 2.5% (intended to apply to future rights, accrued from January 2009); and

- repeal the rules on "safeguarded rights", which currently apply when a pension is shared on divorce or dissolution of a civil partnership.[31]

The decisions taken by the Government on different issues raised by the review are covered in more detail below.

Comment

Responses to the Government's October 2007 proposals were mixed. They were welcomed by the CBI as a "sensible first step."[32] The National Association of Pension Funds (NAPF) said they would "help sustain the future of defined benefit pensions, which provide valuable income to millions of working people in retirement."[33] In an article in the *Financial Times,* Joanne Segars, Chief Executive of NAPF, said the Government was proposing a package of measures to "help support occupational scheme sponsors by cutting back on pension scheme regulation":

> Since 1995 there have been 689 sets of regulations issued on pensions, excluding tax regulations. That is about one a week. So it is easy to see why deregulation is needed so badly. The government's proposals include a number of helpful measures that will allow scheme sponsors some additional flexibility while at the same time balancing the interests of scheme members.

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30 Ibid

31 DWP, Deregulatory review – Government response to consultation, December 2007

32 CBI Press Release, 22 October 2007, CBI comment on DWP Proposals to Deregulate Pensions

33 NAPF Press Release PR44/07, 22 October 2007, NAPF welcomes Government's deregulatory review response,

> Proposals include giving trustees a statutory override so they can bring their rules into line with the latest legislation, and allowing schemes to reduce from 5 per cent to 2.5 per cent the inflation proofing on deferred pensions - the pensions people leave behind when they change jobs. The latter is certainly a proposal that has attracted much attention. But it is important to remember that it does not impact on the benefits that scheme members have already built up. What these changes can do, though, is increase the likelihood that occupational pension schemes can be sustained so that workers can build up defined benefits in the future.[34]

The TUC welcomed the fact that the Government had resisted calls to end Limited Price Indexation (LPI) for pensions in payment, but was "very disappointed at the proposal that the cap on the revaluation of deferred pensions should be cut from 5 per cent to 2.5 per cent, against the recommendation of the review."[35] The Association of Consulting Actuaries described the Government's response so far as inadequate:

> We are very disappointed at the modest deregulatory reforms accepted so far by the Government in this paper. Whilst these are welcome, they are by no means anything like enough to encourage employers to continue to provide good occupational schemes, particularly defined benefit schemes.[36]

A letter to *FT* said the deregulatory review was "playing at the fringes in its attempt to control costs."[37]

3 Individual issues

3.1 Limited Price Indexation (LPI)

Before April 1997 there was no general obligation on Defined Benefit schemes to increase pensions in payment (although contracted-out schemes have had to bear part of the cost of index-lining contracted out Guaranteed Minimum Pensions (GMPs) accrued since 1988.) In practice, however, it appears that many schemes applied some form of inflation protection to pensions in payment.[38] The *Pensions Act 1995,* introduced a general requirement that pension arising from an occupational pension scheme accruing from 6 April 1997 had to be increased at a minimum by Retail Prices Index (RPI) capped at 5%.[39] This is known as Limited Price Indexation (LPI). In practice, however, it appears that many schemes applied some form of inflation protection to pensions in payment.[40]

The Pickering Report on pensions simplification, published in July 2002, recommended that LPI should be abolished on the grounds that it was "disproportionately expensive."[41] The Government said it was unwilling to make changes to the LPI unless it "had good reason to believe that the coverage of and contributions to occupational pensions would be higher than

34 'Welcome deregulation for DB sponsors', *Financial Times,* 12 November 2007
35 TUC Press Release, Deregulation review "goes a step too far", says TUC, 22 October 2007
36 Association of Consulting Actuaries Press Release, 22 October 2007, ACA says Government's Response Totally Inadequate So Far
37 Financial Times, 3 November 2007, *Do not forget accrued rights in pension plans policy* (letter from Paul Greenwood, Foresight Trustees)
38 Lewin and Sweeney, Deregulatory Review of Private Pensions. A Consultation Paper, March 2007, p10
39 *Pensions Act 1995,* section 51
40 Lewin and Sweeney, Deregulatory Review of Private Pensions. A Consultation Paper, March 2007, p10
41 *A simpler way to better pensions. An independent report* by Alan Pickering. July 2002, para 2.10-11

would otherwise be the case." [42] In its June 2003 occupational pensions White Paper, the Government announced that it had decided to reduce the LPI cap to 2.5%:

> 10. We have therefore decided that we will relax this requirement, so that schemes are required only to index pensions in payment by inflation, as measured by the September annual increase in the Retail Price Index (RPI), capped at 2.5 per cent each year. This reflects the reality of an economic climate where inflation has been driven down to average just 2.4 per cent over the years since 1997. The change will also better align the regulation of defined benefit and defined contribution schemes – members of the latter are not generally obliged to purchase any cover against inflation at all.[43]

This was implemented for DB schemes by the *Pensions Act 2004*, with effect from April 2005. Since April 2005, there has been no requirement that pension rights secured in a DC arrangements should be secured by a scheme pension or lifetime annuity that increases annually once in payment.[44]

The external reviewers described the proposal to remove the requirement for Limited Price Indexation (LPI) as "one of the most controversial of the deregulatory changes we were asked to consider."[45] It was an area on which they were unable to agree:

> 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.[46]

The Government decided not to remove the requirement on the grounds that it was an important protection for members and there was no clear evidence that removing it would have a direct and significant effect on employer provision:

> Removing the requirement to increase pensions in payment has the potential to deliver significant savings for employers, but at the expense of future pensioners. In the absence of clear evidence that removing the LPI requirement would have a direct and significant effect on employer provision, the Government does not believe that the removal of such an important protection for members would strike the right balance between employer concerns and member protection and has therefore decided not to make any changes to the current requirements.[47]

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42 DWP, Simplicity, security and choice: Working and saving for retirement, December 2002, Cm 5677, chapter 4, para 45

43 DWP, Simplicity, security and choice: Working and saving for retirement. Action on occupational pensions, June 2003, Cm 5835, Chapter 3, paragraph 10

44 *Pensions Act 2004,* sections 278 and 279

45 Lewin and Sweeney, Deregulatory Review of Private Pensions. A Consultation Paper, March 2007

46 Ibid, Executive Summary

47 DWP, Deregulatory review – Government response, October 2007, p5-6

This decision was welcomed by the TUC.[48] The CBI, in its response to the external reviewer's consultation paper in March 2007 said:

> CBI members have considered the proposal to make LPI increases to pensions in payment discretionary – as is the case in defined contribution schemes. Such a proposal would provide increased flexibility for employers but consultation with CBI members indicates that few members would choose to implement such a measure. Given the very low take-up of this option it would have very limited impact in securing defined benefit provision in the future.[49]

The Association of Consulting Actuaries had argued that the LPI should be removed in respect of future service:

> The ACA strongly supports the removal of mandatory indexation of pensions in payment in respect of future service within a defined benefit scheme. Employers should still be able to provide non-discretionary or discretionary increases to pensions in payment reflecting the financial condition of the scheme.[50]

The Government's December 2007 response to consultation said:

> Individual and trade union respondents welcomed the Government's decision and commented that any change here would institutionalise poverty among the elderly population.
>
> Organisations and employers, however, were disappointed - some felt that such a change would have been a much more significant encouragement to employers to maintain or even re-open defined benefit pension schemes.[51]

3.2 Reduction in the cap applying to the revaluation of deferred benefits

Revaluation of pension entitlement of early leavers prior to retirement age has been required in some form since 1986.[52] The purpose was to protect those who changed jobs during their career. The then Secretary of State for Social Services, Norman Fowler said:

> At present many people who change their jobs leave behind a pension, which is basically frozen in cash terms and, therefore, loses value up to the age of retirement. That provides the most fundamental complaint about the present arrangements. I shall therefore introduce legislation to require occupational pension schemes to revalue deferred benefits for future early leavers at 5 per cent a year compound or in line with prices, whichever is less, over the whole period from leaving to pension age.[53]

Part IV of the *Pension Schemes Act 1993* required deferred pension entitlement to be revalued in line with the retail price index, capped at 5% until the benefits are taken or the early leaver reaches normal pension age.

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48 TUC Press Release, Deregulation review "goes a step too far", *says TUC*, 22 October 2007

49 CBI official response to Sweeney/Lewin Deregulatory Review of Private Pensions, 30 April 2007

50 Association of Consulting Actuaries, *Response to the Deregulatory Review,* April 2007

51 DWP, Deregulatory review – Government response to consultation, December 2007, p10

52 Lewin and Sweeney, Deregulatory Review of Private Pensions. A Consultation Paper, March 2007 p12; *Pension Schemes Act 1993,* Part IV

53 HC Deb, 11 June 1984, cc642-3

Chris Lewin and Ed Sweeney were asked to consider whether the cap on mandatory revaluation should be reduced to 2.5% for service going forward. They saw good arguments on both sides:

> 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.
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> 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.
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> 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. [54]

They did not recommend a reduction in the cap:

> 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 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.[55]

However, they did say that they 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 encourage provision.[56]

The Government has said it would seek views on proposals to reduce the cap on revaluation of deferred benefits for all pension rights accrued on or after a future date from 5% to 2.5%:[57] In December 2007, it said that the proposal to reduce the cap had been "generally welcomed by organisations representing employers and pensions industry", although most also cautioned against any expectation that a change on revaluation alone would have a significant impact on employers' decisions to continue with defined benefit pension schemes.

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54 Lewin and Sweeney, Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions, July 2007, p6

55 Ibid, para 81

56 Ibid, Executive Summary, para 5

57 DWP, Deregulatory review – Government response, October 2007, Executive Summary

Most individuals and organisations representing members of schemes, such as the TUC and affiliated trade unions and the Occupational Pensioners' Alliance, "were strongly opposed to any change to the cap." The Government said it had decided to reduce the cap to 2.5%:

> Taking all of the representations, for and against, into account, the Government has decided to proceed with this proposal, and to reduce the level of the cap going forwards to 2.5%, in line with the original policy intention to provide a degree of, but not total, protection against the effects of inflation. It believes that this achieves a balance between encouraging good employer provision while sufficiently protecting members' interests, and a relevant provision will be included in the forthcoming Pensions Bill. [58]

Provision to reduce the cap was included in the *Pensions Bill 2007-08.* In debate on the legislation, the then Liberal Democrat Shadow Secretary for Work and Pensions, Danny Alexander, noted the different views on the issue from organisations such as the National Association of Pension Funds and the Engineering Employers' Federation on the one hand and the TUC on the other.[59] Shadow Pensions Minister, Nigel Waterson supported the measure, agreeing with the NAPF that it was "an important first step."[60]

Section 101 and Schedule 2 of the *Pensions Act 2008* reduced the cap on the required revaluation of deferred pension benefits, for future accruals from 6 April 2009:

> The overall effect of the amendments is to provide that accrued benefit attributable to pensionable service on or after the commencement day is to be revalued by the rate of inflation over the relevant revaluation period, capped at 2.5% per annum. Accrued benefit attributable to service before the commencement day is to be unaffected by the amendments and a cap of 5% per annum is to continue to be applied to accrued benefits for service between 1985 and the commencement day. Where the time period between the end of pensionable service and the beginning of pension payments is longer than a year, the caps are applied to the rate of inflation as averaged over that time, and are calculated on a compound basis.[61]

In September 2009, the Society of Pension Consultants called on the Government to consider scrapping the requirement to index-link pensions in payment.[62]

3.3 Statutory override

Chris Lewin and Ed Sweeney found that some schemes were prevented from making changes to scheme rules to allow benefit changes for future service where such changes were made possible by changes in legislation:

> 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.[63]

58 DWP, Deregulatory review – Government response to consultation, December 2007, p4-5
59 PBC Deb, 7 February 2008, c454-5
60 Ibid, c454-7
61 Pensions Act 2008 – Explanatory Notes; *Pensions Act 2008 (Commencement No 2 Order) 2009* (SI 2009/82)
62 Miles Costello, SPC calls for end to annual rise in final salary pensions, *The Times,* 21 September 2009
63 Lewin and Sweeney, Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions, July 2007, p24

They argued that any statutory override to scheme documents would need to be narrowly drawn to assure the balance of powers intended under the scheme rules was maintained:

> 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 agree.[64]

The Government consulted on proposals to introduce a statutory override to enable schemes to take advantage of two particular legislative changes: the reduction to 2.5% in the cap on required LPI introduced by the *Pensions Act 2004*; and any reduction in the cap on revaluation (see section 3.2 above).[65] It asked whether an override should only be available providing both trustees and employers agree to the appropriate change.[66] It was proposed that the override would only apply to pensions accrued from a future date.[67]

In its December 2007 response to the consultation the Government said the statutory override should only be exercisable with the proper agreement of both trustees and employers. Regulations were to be brought forward in due course:

> The issues around the concept of a statutory override, and who should operate it, are finely balanced. There is a strong argument that the Government should do its best to ensure that schemes can take advantage of any relaxations it introduces to existing statutory requirements, but it is less clear that this should extend to giving employers a unilateral power to make consequential changes to scheme rules, irrespective of the historical circumstances of any given scheme.
>
> The Government has decided, therefore, that overrides to enable scheme rules to be amended to reflect the 2004 change to the indexation cap for service going forward and for the future change to the revaluation cap should only be exercisable with the proper agreement of both trustees and employers. This should still help those schemes whose restrictive rules do not even allow the employer to open negotiations with trustees for changes for future rights. Such a provision could be delivered through secondary legislation and the Government proposes to bring forward appropriate regulations in due course.[68]

In debate on the *Pensions Bill 2007-08,* Shadow Minister for Work and Pensions, Nigel Waterson argued that a limited statutory override should be included in the Bill.[69] In response, the then Pensions Reform Minister, Mike O'Brien explained that the Government intended to issue regulations for consultation later in the year.[70]

Legislation to introduce the statutory override, from 6 April 2009 is included in the *Occupational, Personal and Stakeholder Pensions (Miscellaneous Amendments) Regulations 2009 (SI 2009/615)*:

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64 Ibid, p24
65 DWP, Deregulatory review – Government response, October 2007, Executive Summary
66 Ibid, p10
67 Ibid, Annex B, Impact Assessment, p35, para 2
68 DWP, Deregulatory review – Government response to consultation, December 2007, p7
69 PBC Deb, 21 February 2008, c583
70 Ibid, c585

> Where a pension scheme wants to change the rate or amount by which it revalues accrued pension benefits or increases pensions in payment, these new powers can be used provided the employer agrees. In particular, it will allow changes to be made where the scheme rules do not allow that change.[71]

The provision is expected to have an impact over the longer term:

> The aim is to enable trustees to amend scheme rules to take advantage of the reduced statutory indexation and revaluation caps. This will provide significant savings for defined benefit (DB) schemes, thus helping to maintain high quality DB provision. RPI inflation is currently well below 2.5% so there wont be benefits to employers and costs to employees in the short run - but pensions are a long term business and the changes are still appropriate. Changes to the revaluation cap are estimated to allow possible savings to schemes of between £250 million and £400 million over the long term.[72]

An Early Day Motion has been tabled arguing that the regulations should be annulled:

> EDM 1242, PENSIONS (S.I., 2009, No. 615)
> 31.03.2009, Cameron, David
> That an humble Address be presented to Her Majesty, praying that the Occupational, Personal and Stakeholder Pensions (Miscellaneous Amendments) Regulations 2009 (S.I., 2009, No. 615), dated 10 March 2009, a copy of which was laid before this House on 16 March, be annulled.

Pensions Week reported that the purpose was to trigger a debate on the scope of the statutory override:

> Shadow pensions minister Nigel Waterson said: "These are complex regulations that deserve a proper debate instead of being rubber-stamped. "We also have concerns regarding statutory override . As the instrument is currently drafted, pension schemes would only be able to amend their rules by trustee resolution and not by employer initiative." The EEF, the manufacturers' organisation, and the Confederation of British Industry, had hoped the government would introduce the measure to ease the burden on the sponsors of DB schemes. However, the government decided the statutory override should be carried out by only the trustees with the consent of the scheme's employer. David Yeandle, head of employment policy at the EEF, said: "I will be encouraging Nigel Waterson to press for the override in these regulations to be extended."[73]

3.4 Measures to encourage risk-sharing schemes

The external reviewers noted that there were a number of possible ways of providing a pension, between the two extremes of a Defined Benefit final salary pension scheme and a "pure" Defined Contribution scheme:

> 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

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71 Explanatory Memorandum to the *Occupational, Personal and Stakeholder Pensions (Miscellaneous Amendments) Regulations 2009 (SI 2009/615),* para 7.1

72 Ibid, p 8

73 Tom Willetts, Tories seek to postpone override regs, *Pensions Week,* 6 April 2009

> 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.[74]

They looked at different models of pension provision which aim to share the risk between employer and employee. It was suggested to the reviewers that a regulatory framework should be designed to allow a third type of scheme which was neither traditional final salary nor defined contribution:

> The type of scheme envisaged would be one where members would accrue benefits on a career average basis, and the age at which the benefits became payable (normal pension age) could move by reference to a longevity index calculated by the actuary. Increases to pensions in payment and revaluation of pensions would be targeted, rather than guaranteed, and would only be paid where scheme funding allowed - in effect, this would remove the requirement to provide LPI and revaluation for these schemes.[75]

The Association of Consulting Actuaries argues that this sort of "conditionally indexed pension scheme" can "offer the prospect of higher investment returns over the long term, and therefore lower costs, due to fewer constraints on investment strategy"[76]

Conditional indexation is allowed in the Netherlands. An OECD working paper produced in 2007 explains that this has "greatly enhanced the pension fund's control over their pension benefit levels":

> The Netherlands is still overwhelmingly a 'DB country', but most plans have been transformed from final salary to average salary ones. The Dutch pension funds worked successfully on restoring their financial position via a highly flexible system of burden sharing between the stakeholders.
>
> Retirement benefits are paid as lifelong pensions. Indexation of pension benefits is an explicit goal of the pension policy of the Dutch pension funds, but indexing is neither stipulated by law nor an unconditional commitment of the funds. According to the new pension law, pension funds must explicitly declare their indexation policy and the conditions for indexing.
>
> With the shift from final salary plans to average salary plans, conditional indexing has become an especially powerful financial steering instrument for pension funds in the context of the pension deal. As only the nominal benefit is guaranteed, the indexation cutting instrument can be applied also to the benefit accruals of the active workers. The change to a conditional index-linked average-salary scheme during the last three years greatly enhanced the pension funds' control over their pension benefit levels.[77]

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[74] Lewin and Sweeney, Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions, July 2007

[75] DWP, Deregulatory review – Government response, October 2007, p12

[76] Ibid

[77] OECD, Protecting Pensions. Policy Analysis and Examples from OECD countries, 2007 p203

The external reviewers considered the case for a third type of legislation to support this sort of scheme but felt that such an approach would not be in line with their terms of reference, which "strongly underline a deregulatory purpose".[78]

The Government said wished to give further consideration to a third layer of legislation. It would also examine the basis for PPF compensation for members of risk-sharing schemes.[79] However, in December 2007 it remained to be convinced about conditional indexation.[80] In December 2008, it said it would look further at a number of reforms that could be made under the current legislative framework. It had decided not to legislate for conditional indexation:

> The opposing views expressed by respondents to this consultation reinforce the need to be vigilant in striking the "balance between member protection and encouraging employer provision of pensions."
>
> The consultation responses included a wide range of suggestions in response to questions about the range of options under **the current framework** and what could be done to make risk sharing easier to achieve. On the basis of these suggestions the Government will take forward the following areas of work:
>
> - Consider, with the Pensions Regulator (TPR), what could be done to share information on current risk sharing practices more widely still.
> - Work with practitioners and pension lawyers to develop proposals for regulations that will ensure schemes have more scope to introduce flexibility in the way pensions accrue for future service to reflect changing longevity with the aim of consulting by spring 2009 at the latest.
> - Gather further evidence on whether the requirement to index pensions in payment is appropriate for cash balance schemes and subsequently consider the practical consequences of abolishing this requirement.
> - Institute a general review of the burdens imposed by the arrangements for contracting out.
> - Take forward other wider deregulatory review initiatives such as on employer debt.
>
> Removing mandatory indexation would be a simple and radical deregulation, and although the Government rejected this proposal when it was raised by Chris Lewin in his report with Ed Sweeney, it has now seriously examined the case for reversing that decision in the light of responses to this consultation. However, in the absence of compelling evidence that such a move would reinvigorate DB provision, the Government still believes that the removal of this important protection for members would not strike the right balance between employer concerns and member protection.
>
> The Government has carefully considered the arguments for and against conditional indexation. Significant additional regulation would be required to provide an

[78] Lewin and Sweeney, Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions, July 2007, p26

[79] DWP, Deregulatory review – Government response, October 2007, p 13

[80] DWP, Deregulatory review – Government response to consultation, December 2007, p8-9

[80] DWP, Deregulatory review – Government response to consultation, December 2007

appropriate framework for such an approach and the complexity would inevitably hamper member understanding and potentially undermine member confidence. The Government is also unconvinced that there is sufficient demand from employers to justify taking such measures. Finally, the consultation has demonstrated that there is, at present, no workable consensus on this proposal.

> The Government's view is that the consultation has not provided the weight of evidence that this proposal is likely to make the significant impact on the level of DB provision that would have justified overriding the concerns of member representatives. It has therefore decided not to pursue conditional indexation at this time.[81]

The Government is to undertake further work on the detail of how "collective DC schemes" might operate in the UK.[82] In the Netherlands, such schemes work in a similar way to conditional indexation schemes, with expected benefit levels still calculated according to average salaries:

> 4.16 The key difference is that such schemes set a fixed employer contribution, meaning that nominal benefits are not guaranteed in the same way as under a conditional indexation scheme. The conditional indexation element and cuts to accrued benefits bring no direct financial benefit to the sponsor who always pays a fixed contribution. On this basis, these schemes are classed as DC rather than DB. The introduction of this type of scheme is a recent development and it therefore remains to be seen whether an employer would, in practice, bail out a collective DC scheme if it was significantly underfunded.[83]

The decision not to pursue conditional indexation was met with some disappointment. The chair of the Association of Consulting Actuaries said that:

> Without a new 'middle way' option that better allows employers to cap DB costs for the future, the vast majority of private sector employees will be moved into defined contribution. The absence of choice under the current legislation leaves few other realistic options – but the absence of choice certainly won't halt defined benefit scheme closures.[84]

Joanne Segars, Chief Executive of the National Association of Pensions Funds said:

> A clear opportunity to ease the pressure on employers who support defined benefit pension schemes has been missed. In the current economic climate, a bold approach is needed to secure defined benefit provision in the same way a bold approach has been taken for other parts of the financial sector.

However, Hamish Wilson said a move towards "collective DC could solve the problems of public sector pensions."[85]

3.5 Section 67, the *Pensions Act 1995*

Section 67 of Pensions Act 1995 sets out the conditions under which the subsisting rights of pension scheme members can be modified. As originally enacted, it prohibited changes to the rules of a scheme which would reduce a member's accrued pension rights without the

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81 DWP, 'Risk sharing consultation: Government response', December 2008
82 Ibid, p2
83 DWP, 'Risk sharing consultation', June 2008
84 Jemma Towler, 'Rejection of indexation spells death knell of DB', Professional Pensions, 18 December 2008
85 Ibid

member's consent. The Pickering Report on pension simplification argued that this prevented defined benefit schemes from making perfectly sensible changes which would leave the members no worse off overall, and was a contributory factor in many decisions to close down defined benefit schemes.[86]

Section 67 was substantially amended by the *Pensions Act 2004*. Under the new rules, only detrimental changes to subsisting rights are covered, and trustees may make changes without consent, so long as each member from whom consent has not been obtained retains benefits that are actuarially equivalent to those he had prior to the change.[87] Chris Lewin and Ed Sweeney were asked to look at this issue. The rejected the proposal that section 67 should be disapplied to accrued pension rights:

> 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.[88]

Some in the industry were concerned that section 67 was open to misinterpretation and that even a contingent promise could be "construed to result in an accrued benefit, even in circumstances where the contingency had not occurred." However, the reviewers felt this concern might be overblown and recommended that the new section 67 should be given time to bed down:

> **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.[89]

The Government agreed to keep section 67 under consideration:

> The Government and the Pensions Regulator agree with the reviewers that section 67 should not prevent schemes from drafting rules in such a way that benefits in respect of future service are linked to clearly defined contingencies. However, the Government is mindful that it is ultimately for the courts to determine how statute applies in particular circumstances. Any employer or scheme considering amending existing scheme rules or setting up a new scheme should consider taking their own legal advice so that the particular circumstances in their case can be fully taken into account.
>
> The Government agrees that it is too early to assess the impact of section 67 and to obtain information about any possible unintended effects and accepts the reviewers' recommendation that DWP should keep section 67 under consideration.[90]

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[86] Alan Pickering, *A simpler way to better pensions*, July 2002, para 4.26-4.33

[87] Lewin and Sweeney, Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions, July 2007, p14

[88] Ibid, p14

[89] Ibid, p15

[90] DWP, Deregulatory review – Government response, October 2007, p12-3

3.6 Circumstances which trigger an employer debt calculation

Chris Lewin and Ed Sweeney explained in their report how the current rules work where an employer exits a multi-employer scheme:

> 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.[91]

The reviewers had recommended that there should be a twelve month period of grace before a "cessation event" should be triggered. This, they said, would alleviate many of the problems experienced by small employers with only a few staff. The Government had already accepted this.[92]

The reviewers set out their general thinking on employer debt in the context of group reorganisation:

> **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.[93]

In its response, the Government said the purpose of the legislation on employer debt (Section 75 of the *Pensions Act 1995*) is to "ensure that an employer cannot 'walk away' from their pension obligations without ensuring that they are properly funded."[94] It accepted that the provisions could create difficulty for employers wishing to undertake a reorganisation and said it would continue to look at the issue:

> The Government also accepts that the current provisions may create difficulties for employers who wish to undertake a reorganisation and believes that, in principle, there is much to be said for distinguishing between reorganisations and complete severance of an employer from a scheme. However, this is a difficult area and it may not be easy to find a way to address this without creating loopholes within legislation. In addition to the changes already outlined in draft amending regulations, the Government intends to work with the industry over the coming months to seek a practical solution to the

91 Lewin and Sweeney, Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions, July 2007, para 142

92 *The Occupational Pension Schemes (Employer Debt and Miscellaneous Amendment) Regulations 2008* (SI 2008/731) came into force on 6 April 2008.

93 Lewin and Sweeney, Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions, July 2007

94 DWP, *Deregulatory review – Government response, October 2007,* p14

> difficulties created by the current provisions which does not undermine the principle that employers should fully meet their pension obligations.[95]

The Government's December 2007 response to consultation said it might not be easy to address this area without creating loopholes. It said it intended to "work with the industry over the coming months to seek a practical solution to the difficulties created by the current provisions which does not undermine the principle that employers should fully meet their pension obligations."[96]

In November 2008, the Government said it was conducting an "informal review" of section 75 and that a formal consultation might follow.[97] In May 2009, Parliamentary Under Secretary of State Lord McKenzie said that if the Government did decide that amendments to the employer debt regulations were needed, it would consult on draft regulations in due course.[98]

In September 2009, the Government issued a consultation Employer Debt (Section 75 of the Pensions Act 1995) Consultation on draft regulations. The Government said:

> […] commentators have argued that one effect of the legislation has been to unnecessarily inhibit corporate activity, in particular to hinder the ability of companies to restructure in order to be better able to deal with changes in the economic environment. The Government has acknowledged these problems and has been working with the pensions community to resolve them. The draft regulations which form part of this consultation give effect to the new proposals.[99]

According to the *Financial Times,* the proposals were welcomed by the CBI, while the TUC said it would scrutinise them carefully:

> Under the new proposals, associated employers undertaking a restructuring will no longer have to pay the pensions debt, provided that the assets and employees are passed over to another company in the group. In addition, the receiving employer will have to pass a test showing it is at least as likely as the original employer to be able to meet pension liabilities. The receiving employer must also have its head office in the UK.
>
> When the government originally said it was thinking of changing the rules, the Trades Union Congress expressed alarm that any change to the so-called Section 75 rules would weaken employees' pension protection. The government was also worried that any change could lead to employers trying to walk away from pension liabilities, with more schemes falling into the Pensions Protection Fund, the pensions' lifeboat.
>
> Yesterday the TUC said it "recognises that there is case for change", but added that "we will scrutinise the proposals carefully to ensure that scheme members' rights are fully protected".
>
> Neil Carberry, head of pensions at the CBI, said it welcomed the proposals, while wishing they went further. However, he said "this is clearly a step forward."[100]

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95 Ibid
96 DWP, Deregulatory review – Government response to consultation, December 2007
97 HL Deb, 19 November 2008, c1160
98 Lord McKenzie, speech to the Financial Times Buyout and De-risking Summit 'The impact of financial turmoil on the market', Tuesday, 19th May 2009
99 Page 3
100 Nicholas Timmins, 'Company pension rules shake-up mooted', the *Financial Times,* 18 September 2009

> Angela Eagle, the pensions minister, said she believed the change "could help up to 50 per cent of corporate restructurings without undermining protection of employees' pensions". But she said she would be "interested in seeing the market response to this consultation".

3.7 Return of surplus defined benefit funds to an employer

There are a number of ways in which the level of a pension scheme's funding can be measured, including:

- Ongoing valuations obtained by trustees and used to determine cash contribution levels. Trustees of Defined Benefit (DB) schemes are required to undertake a full actuarial valuation of a scheme's assets and liabilities at least every three years.[101]
- FRS17/IAS19 (Financial Report Standard 17 or International Accounting Standard 19, its international equivalent). For accounting periods beginning on or after 1 January 2005, UK listed companies are required to report their pension costs in accordance IAS 19, while UK companies not listed on the stock market can choose whether to report their costs using FRS17 or IAS19;and
- "Full buy-out", which is the amount that would need to be paid to an insurance company for it to take on the liabilities.

The main differences lie in the way liabilities are valued.[102]

Currently, before the trustees can consider a return of funds to the employer, scheme funding must buy-out level and the trustees must be satisfied that it would be in the member's interests to do so.[103]

The external reviewers reported concern from scheme sponsors that as schemes funding improved, resources that would never be needed for pension benefits would become trapped in pension funds. They were asked to consider changes to increase employer confidence that funds will not be trapped.[104] They recommended that a return of surplus should be allowed where the scheme has reached the scheme funding targets and trustees agree:

> 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.[105]

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101 The scheme specific funding requirements introduced by the *Pensions Act 2004* are covered in more detail in Library Standard Note, SN/BT/4877, Pension Scheme Funding.

102 The Pensions Regulator, 'How the Pensions Regulator will regulate the funding of defined benefits, Consultation document', October 2005

103 Lewin and Sweeney, Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions, July 2007, p34

104 Ibid, p34

105 Ibid, p35

The Government did not agree with this recommendation, arguing that it could significantly jeopardise the current level of protection for scheme members. However, it undertook to explore the scope for addressing employer concerns further:

> The Government does not agree with the reviewers' recommendation that a return of surplus should, with trustees' agreement, be available once the scheme specific target is reached. The Government is of the view that such a change has potential significantly to jeopardise the current level of protection for scheme members. The recent sharp falls in stock market values highlight the risk of sudden fluctuations in scheme solvency overtaking decisions to return funds to employers, and the consequent risks to the Pension Protection Fund. On the other hand, the Government recognises the concerns that some employers may have about funds building up in their scheme when the test for recovering any surplus is so stringent. Over the coming months we will work with employers, and other stakeholders, to explore the scope for addressing these concerns.[106]

Organisations such as CBI have argued that there should be a change in the rules:

> Many CBI members perceive the regulations guiding the return of surplus to employers as unduly restrictive. Members believe more flexibility may be necessary in the future if surpluses start to arise. The CBI therefore believes that this issue should be kept under active review.[107]

In the Government's response to consultation said it would continue to work with stakeholders on the issue:

> The Government recognises the concerns that some employers may have about funds building up in their scheme in the current legislative environment. Over the coming months, it will work with employers, and other stakeholders, with a view to considering if there may be scope for addressing these concerns in other ways. These might include, for example, considering whether there are options open to the Pensions Regulator to clarify and expand guidance in this area.
>
> The Government has decided not to pursue the removal of the requirement in the *Pensions Act 1995* for trustees to be satisfied that a payment of surplus to the employer must be in the scheme members' interests. It has proved difficult to address concerns about this requirement without the risk that its removal might suggest to the Courts that Parliament was actually reducing trustees' current obligations to scheme members. As part of the further work mentioned above, the Government will also explore other means to address this.[108]

3.8 Principles-based approach

The reviewers were asked for their opinions on principles-based regulation. They recognised concerns around this:

> 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.

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[106] DWP, Deregulatory review – Government response, October 2007, p15

[107] CBI official response to Sweeney/Lewin Deregulatory Review of Private Pensions, 30 April 2007

However, they remained attracted to an approach focused on outcomes and wondered whether the current layers of regulation were really necessary:

> 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 code and guidance, all attempting to instruct the scheme administrator concerning one aspect of a particular pensions-related activity.[109]

They recommended an incremental approach to change:

> **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.

Review of Disclosure regulations

The reviewers looked in more detail at how a principles-based approach might apply to the regulations which require pension schemes to disclose certain information to pension scheme members, among others.[110]

In response, the Government said it agreed that the disclosure regulations were a good place to start in attempting to apply a principles-based approach to regulations and that it would take forward work with stakeholders:

> The disclosure of information requirements are spread across more than a dozen sets of regulations and cover various issues. The Government takes the view that replacing all the current requirements with a principles based approach in a single exercise could prove too unwieldy. The Government intends to focus initially on the main disclosure requirements that apply to the day to day running of occupational pension schemes deriving from section 113 of the Pension Schemes Act 1993. The Government will take forward further work with stakeholders to see how the principles based approach is best likely to work.[111]

The Government's December 2007 response to the consultation said there was widespread support for this. However, not all were in favour. The Occupational Pensioners Alliance had said a "principles based approach would make it more difficult to challenge the actions of a pension scheme."[112]

A consultation document issued in March 2009, the Review of Disclosure of Information Requirements applying to Occupational, Personal & Stakeholder Pension Schemes contained proposals to "streamline" the DWP regulations governing disclosure by pension schemes. The Government is to consult on draft regulations later in the year.[113]

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108 DWP, Deregulatory review – Government response to consultation, December 2007, p11

109 Lewin and Sweeney, Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions, July 2007

110 For an overview of the current provisions, see the Pensions Regulator's Guidance to trustees, December 2007, p42-43

111 DWP, Deregulatory review – Government response, October 2007

112 DWP, Deregulatory review – Government response to consultation, December 2007, p15

113 Lord McKenzie, speech to the Financial Times Buyout and De-risking Summit 'The impact of financial turmoil on the market', Tuesday, 19th May 2009

3.9 Pension sharing on divorce

The reviewers recommended that the policy and legislation regarding pensions and divorce should be reviewed with a view to making significant simplification if possible. The Government explained that it would introduce new legislation in this area:

> Pension sharing on divorce was introduced for all new divorces commenced on or after 1 December 2000. When a divorcing couple seek a financial settlement, the court must take into account the value of any pensions held by either party to the divorce. In order to achieve a fair settlement, one of the options available to the court is to make a pension sharing order requiring a percentage of the value of the pension scheme member's shareable pension rights to be transferred to the former spouse. The former spouse's share is then discharged into a pension arrangement as a pension credit.
>
> There are concerns about the complexity of the requirements and the different treatment of pension credit rights. The Government agrees that some of the requirements are unnecessary and at the next suitable opportunity will repeal the legislative requirements relating to safeguarded rights. DWP in consultation with relevant stakeholders will also be looking at the legislation with a view to aligning the payment of pension credit benefits (i.e. those benefits which arise from pension sharing, not state pension credit) with the rules that apply to private and occupational pensions. [114]

The Government later said it would take forward the abolition of safeguarded rights and would look at other aspects of pension sharing legislation.[115]

Clause 100 of the *Pensions Act 2008* abolished safeguarded rights from 6 April 2009. The Explanatory Note says:

> 237. Where, on divorce or dissolution of a civil partnership, rights to a pension are shared under the mechanism in Chapter 1 of Part 4 of Welfare Reform and Pensions Act 1999, and those rights include contracted-out rights, the law as it stands treats the contracted-out rights in a different way from the other shared rights. They are known as "safeguarded rights" and are subject to various restrictions. Section 100 and the related repeals in Schedule 11 abolish these restrictions. Once these provisions are brought into force, shared rights that derive from contracted-out rights will be treated in the same way as other shared rights.[116]

In addition, there is provision *Occupational, Personal and Stakeholder Pensions (Miscellaneous Amendments) Regulations 2009* (SI 2009 No, 615) to allow "benefits payable as a result of divorce or dissolution of a civil partnership to be paid in the same circumstances as apply to other pension scheme members in most pension arrangements", with effect from 6 April 2009.

3.10 Trustees

The reviewers recommended an amendment to legislation on the levels of knowledge reviewers were required to have:

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114 Ibid
115 Ibid, p12
116 *Pensions Act 2008* – Explanatory Notes; *Pensions Act 2008 (Commencement Order No. 2) 2009 (SI 2009/82)*

> 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. Chris Lewin also recommended that the Government should develop plans for a broad statutory indemnity for trustees of pension schemes.[117]

In response, the Government said it did not think legislative change was needed. It would work with the Pensions Regulator to address misconceptions about the existing requirement for trustee knowledge and understanding:

> **2.9.2 Government response**
>
> The Government and Regulator are of the view that the legislation as it currently stands does not require trustees to have comprehensive knowledge of all the issues. The Government do not consider that it would be appropriate to amend legislation in a way which could lead individual trustees to believe that they do not need to attain even a basic understanding of more complex issues where there are experts in that field on the board. This would be inconsistent with each trustee's fiduciary duty, and could compromise the ability of non-specialised trustees to challenge information presented to them, and result in proposals not being exposed to meaningful consultation by trustee boards. However, the Government accepts that there may be widespread misconceptions about the existing requirement for trustee knowledge and understanding. The Government will work with the Pensions Regulator to examine how best to put right these misconceptions.
>
> The Government does not agree with the reviewers' recommendation for overriding legislation to provide for reasonable personal legal expenses of trustees that arise from the performance of their duties to be reimbursed by the scheme or with the recommendation from one of the reviewers that Government should develop plans for a broad statutory indemnity for trustees of pension schemes.
>
> There is no significant evidence that the absence of any specific legislative provision relating to the re-imbursement of personal legal expense is causing problems in recruiting and retaining trustees, and schemes can (and do) manage trustee personal liability issues effectively on a scheme-by-scheme basis in a way which meets their particular needs. Usually trustees are provided with protection either through insurance cover, an employer indemnity or an indemnity in the trust deed.[118]

In its December 2007 the Government said it would be "be discussing with the Pensions Regulator what clarification can be offered to trustees and trustee boards."[119] Information on what the Pensions Regulator is doing in this area can be found on the Trustee pages on its website and its Annual Report and accounts, 2008-09 (in particular, pages 25-30).

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117 DWP, Deregulatory review – Government response, October 2007, para 159

118 Ibid, page 18

119 DWP, Deregulatory review – Government response to consultation, December 2007, p13

3.11 Trivial commutation

The *Finance Act 2004* introduced the "pension tax simplification" regime, which came into effect in April 2006. This prescribed the circumstances in which part or all of a pension fund could be taken in the form of a lump sum. One of these is as a "trivial commutation lump sum". HMRC explains:

> If the total value of all your pension savings (in all schemes if you are a member of more than one scheme) is £16,500 or less in 2008/09, and your scheme rules permit, you may be able to take your entire fund as a lump sum. This is known as 'trivial commutation'. 25% of the lump sum will be tax-free and the rest will be taxed as part of your income. Trivial commutation of pensions already in payment is fully taxable as income.[120]

The reviewers reported regulatory difficulties regarding trivial commutation, which they said should be resolved as quickly as possible.[121] In response, the Government said it was discussing the issue with interested parties:

> The *Finance Act 2004* sets out the circumstances where a small pension can be commuted into a lump sum. The requirement is that the value of all the members' pension rights are less than 1 per cent of the current lifetime allowance and that the commutation takes place within a twelve month window. This applies to all commutations from 6 April 2006 and contrasts with the regime which applied before then. Before 6 April 2006, a pension could be commuted if it was less than £260 per annum, and no account had to be taken of any other pensions in payment. At the 2006 Pre-Budget Report in response to pensions industry concerns over administration of trivial commutation the Government announced that HMRC would discuss with interested parties the administration of the trivial commutation rules. These discussions are ongoing.[122]

The Government said it would consider the issue."[123]

In Budget 2008, it was announced that:

> 8. Additionally, some easements will be made to the rules for 'trivial commutation' – the circumstances in which pension rights giving rise to very small pension entitlements can be commuted into a lump sum up to 25 per cent of which would be tax free. Regulations under the widened power set out above will provide that it will be possible to commute some small 'stranded pots' as well as pension savings below £2,000 in occupational pension schemes. These will have effect in addition to the current rule that restricts the aggregate of an individual's pension savings to £16,000 for trivial commutation.[124]

Legislation to introduce the change was in the *Finance Act 2008* (section 92 and schedule 29) made provision for "stranded pots to be commuted as lump sums and to allow a de minimis limit for commutation payments by occupational schemes." HMRC issued the draft *Registered Pension Schemes (Authorised Payments) Regulations 2008* for consultation in

[120] HMRC, Pension tax and you, March 2009

[121] Lewin and Sweeney, Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions, July 2007

[122] DWP, Deregulatory review – Government response, October 2007, p19

[123], DWP, Deregulatory review – Government response to consultation, December 2007, p15

[124] HMRC, Budget 2008 Notes, BN 42, Pensions: Regulation making powers,

March 2008. The *Registered Pension Schemes (Authorised Payments) Regulations 2009* (SI 2009/1171) come into force in December 2009. In summer 2009, DWP consulted on regulations that would make "minor amendments to regulations governing occupational, personal and stakeholder pension schemes consequential to changes made to Her Majesty's Revenue and Customs' (HMRC) taxation rules."[125]

[125] DWP, Consultation Document. *The Occupational and Personal Pension Schemes (Authorised Payments) Amendment Regulations 2009* (August 2009)

4 Summary of main recommendations and Government actions

	Reviewers' recommendation	Government response or action
Statutory requirement to increase pensions once in payment (LPI)	Unable to agree on whether the removal of this requirement would encourage strong work-place pension provision	The requirement should not be removed.
Reduction in the cap for revaluation of deferred rights from 5% to 2.5%	Recommended no change, but said they would understand if the Government considered this change to be needed to encourage work-based pensions.	Cap reduced to 2.5% for future accruals from 6 April 2009
Statutory override	Recommended legislation to provide a statutory override where scheme rules prevent schemes making changes for future service where these are allowed in legislation. Extend this to changes introduced by *Pensions Act 2004* to LPI.	Introduction of a limited statutory override to allow schemes to change rules, where trustees agree, to reflect lower revaluation and indexation caps.
Issues relating to risk sharing schemes	Did not recommend a new set of regulations favouring a particular kind of risk-sharing scheme (involving "conditional indexation)	The Government remains to be convinced about "conditional indexation" but is looking further at related issues.
	DWP and the Pensions Regulator (TPR) should confirm the position on the scope for change allowed by section 67 of the *Pensions Act 1995*	Section 67 to be kept under consideration.
Circumstances which trigger an employer debt calculation	Where a company ceases to have employees actively participating in a scheme but the scheme continues, the employer debt should not be triggered if, within a year, the employer acquires more employees who participate in the scheme.	Regulations introduced with effect from April 2008
	Where there is reconstruction in a multi-employer scheme the debt should not be triggered if the original covenant was strong and the remaining employer's covenant remains as strong. Chris Lewin recommended that the debt should also not be triggered if the original covenant was weak and remains unchanged.	Consultation on draft regulations began in September 2009
Return of surplus DB funds to an employer (section 37)	Section 37 should be amended to allow return of surplus where a scheme has reached the scheme specific funding target	Did not agree that return of surplus should be available once scheme specific funding is reached. To work employers

	and trustees agree.	and others to address concerns about funds building up in schemes.
	The requirement that trustees must be satisfied that any surplus return is in the member's interests should be repealed on the grounds that it encourages overly conservative behaviour by trustees.	Did not agree
Principles based approach to legislation and review of disclosure requirements	Renewed emphasis should be place on principles based approach to regulation.	Agreed in principle
	A framework of outcome-related principles should take the place of existing disclosure regulations.	Consultation on proposals closed on 6 May 2009
Pension sharing on divorce	The policy and legislation should be reviewed with a view to making significant simplifications	With effect from April 2009, rules on safeguarded rights abolished; regulations introduced to allow pension credit benefits to be paid in same circumstances as apply to other pension scheme members in most pension arrangements.
Trustees	Legislation should be amended so that individual trustees are not required to have particular standards of knowledge or understanding on a range of issues	The legislation does not require trustees to have comprehensive knowledge of all the issues. Government to work with TPR to address issues.
	A rule should be inserted in all schemes that reasonable personal legal expenses of trustees arising from performance of their duties will be promptly reimbursed by the scheme, subject to power or a court or tribunal to refund this later. Chris Lewin recommended that there should be plans for a broad statutory indemnity for trustees of pension schemes.	Did not agree.
Trivial commutation	The current regulatory difficulties regarding trivial commutation should be resolved by HMRC as quickly as possible.	Regulations to ease trivial commutation rules come into force in December 2009.