

**Deregulatory Review of
Private Pensions**

Deregulatory review -
Response to consultation

5 December 2007

Introduction

On 22 October 2007, the Government published its response to the recommendations in the Deregulatory Review Report provided to Ministers by Chris Lewin and Ed Sweeney. The response sought views on:

- a reduction in the revaluation cap on deferred pensions from 5 per cent to 2.5 per cent for future accruals;
- the introduction of a statutory override to enable scheme rules to be amended to reflect the reduction of the LPI cap from 5 per cent to 2.5 per cent for pensions in payment and/or the proposed reduction in the revaluation cap; and
- the introduction of a third layer of legislation for certain types of risk sharing pension scheme.

This paper outlines the responses received, and the decisions that have been taken following those responses. Where necessary and possible, changes will be taken forward in the Pensions Bill which will be introduced shortly. Others will be taken forward in secondary legislation and/or guidance either in parallel with or following the Bill.

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1 Responses to the consultation

We received 61 responses to the consultation in total, of which 23 were from individual members of the public or interested pensions professionals speaking in a private capacity.¹ The remainder were from organisations, companies or trade unions. A list of those who responded is at Annex A. The Government is grateful to all those who took the time to respond.

1.1 Revaluation

The Government asked for comments on the proposal to reduce the cap on the revaluation of deferred pensions from 5% to 2.5% and for views on whether such a change would usefully reduce burdens on employers providing defined benefit schemes.

1.1.1 Responses received

The proposal to reduce the cap was generally welcomed by organisations representing employers and pensions industry, for example, the NAPF, CBI, the Association of British Insurers, Engineering Employers' Federation and the Co-Operative Group. Others who welcomed it included the Association of Consulting Actuaries, the Society of Pensions Consultants, Watson Wyatt and The British Chambers of Commerce.

Although the reduction in the cap was seen as a welcome move in the right direction, 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. In addition, some noted that the introduction of the change would involve some additional administrative costs. However, the Engineering Employers' Federation (EEF) commented that the reduction in the cap would, "...make it more likely that those schemes that have been closed to new members will decide to remain open for future accruals to existing members". The CBI also believed that the savings generated from the change would be a valuable benefit to businesses and would help to offset some of the rising costs of defined benefit

¹ The Government also received some correspondence from individuals seeking clarification as a result of some inaccurate reports in the press coverage of the Government response, particularly around the revaluation proposal. These were not treated as formal consultation responses and were replied to separately.

provision, ensuring that future accrual by active members can be continued on a more widespread basis.

Most individuals and organisations representing members of schemes, such as the TUC, affiliated trade unions (CWU, Prospect, Connect, GMB) and the Occupational Pensioners' Alliance were strongly opposed to any change to the cap. Their views were also supported by First Actuarial and Standard Life. The main concerns focused on the potential impact of high future inflation, the possible negative impact on labour market mobility and the risk of a disproportionate impact on women and carers. Many felt that any change would in any case have little influence on employers' decisions over continuing provision, and suggested that the uncertainty over the effect of the change on employer behaviour meant that the proposal should not be pursued.

1.1.2 Action

The Government remains concerned about the continuing decline in occupational pension provision and that, if nothing is done, the decline will continue and may even accelerate. Employers have to consider a host of complex factors around their pension provision, not all of which are within Government control. It is clear that there is no single "magic bullet", or, as this consultation has shown, "a consensus option". However, the level of the cap on revaluation is one area where Government action may make a difference, and by returning to the original policy position of providing a degree of, but not total, protection against inflation (and bringing the cap into line with that applied to the indexation of pensions in payment), this measure could, in the longer term, save employers up to £250m a year on average.

Comments from those against the proposal, and much of the press coverage, focused on the potential impact on an individual's pension rights. But it is important to remember that the proposed change will have no impact on any pension rights already deferred², nor on any rights that are accrued by existing scheme members up to the change being made.

There are also many reasons why scheme members build up deferred pension rights, but a common one is that the individual is moving to another job. Deferred pensioners may well have several sources of income in retirement, meaning the impact of the change on an individual deferred pension may not bear particularly heavily on total income in retirement. Analysis shows that the impact of the change to the revaluation cap on average pension income would be small (a reduction of 1.6% by 2050).

The Government acknowledged that there is the possibility of a particular impact on women, as they may be more likely to have broken working histories and therefore

² There are nearly six million deferred pensions.

deferred pensions. The consultation did not produce any new statistical evidence in this area. Defined benefit pension schemes have traditionally been established in male dominated industries at a time when female participation in the labour force was far lower than it is today. Consequently any change to the regulatory framework for defined benefit schemes is likely to impact more on men than women. Employers will also only see any significant savings from the reduction in the cap if they keep their schemes open to future accruals, which would be to the benefit of all scheme members, male and female. Finally, it is important to view this change in the wider context of a series of substantial Government reforms to state and private pensions which aim to narrow the gender pension gap: a modernised contributory principle to reward unpaid caring responsibilities, and automatic enrolment, minimum employer contributions and portability between employers offering personal accounts which should all have major positive impacts on individuals, particularly women.

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.

1.2 Statutory override

The Government asked questions in three areas relating to statutory override:

Should any statutory override to restrictions on amendments in scheme rules only be exercisable if trustees and employers agree to the change, or should it be available to employers without trustee consent?

If trustee and employer consent is appropriate should special provision be made for paid up schemes administered by insurance companies where there is no employer and they are unable to implement Finance Act 2004 changes? Is the inability to make changes creating significant problems for such schemes?

Is there any case for any particular classes of schemes to be exempted from any statutory override? If so, what kind of schemes should be exempted?

1.2.1 Responses received

As with revaluation, the consultation responses on the statutory override proposals were split into two distinct camps. Organisations representing employers were in favour of an override and wanted it to be available for use by employers without trustee consent. The unions and individuals who responded to the consultation were mostly against an override in principle, and in the event that one was provided, they considered that it should be exercisable only with trustee consent.

The EEF and others argued that it was important to have an employer-only override given that the original legislative requirements had been imposed on them. If the Government subsequently decides to relax those requirements, it would be unfair not to give employers, who were responsible for scheme design, the proper tools to revert to the statutory minimum if they wanted to. Many employers, they claim, would have difficulty gaining trustees' agreement to a reduction in the revaluation cap to reflect less onerous legislative requirements.

Some organisations also argued that there was an additional safeguard in that the employer would be required, by legislation, to consult members of a scheme before a reduction to the caps for increasing pensions in payment or revaluing deferred pensions can take place. That is not the case at present. Others suggested an alternative, clearance style approach whereby the trustee board and employer make an application to the Regulator for clearance to change rules for the benefit of the scheme. Such an approach would, however, place the Regulator in a particularly difficult position as it would be very hard to balance all the relevant issues and opposing views, and would be likely to be very resource intensive.

TUC and affiliated unions such as Prospect disagreed strongly with the concept of any statutory override and argued that changes can, and should, be made following negotiation between employer, scheme members and trustees. GMB argued that

allowing employers to take advantage of a statutory override without the consent of the trustees would undermine the trustee board and set a worrying precedent.

The Association of Pensions Lawyers and Eversheds (solicitors) both raised concerns that allowing the employer alone to make use of the statutory override could risk undermining the balance of power in the scheme.

1.2.2 Action

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.

1.3 Risk sharing schemes

Here the Government asked two questions:

Would it be appropriate to introduce a third layer of legislation which would make provision for a specific type of risk sharing scheme and to introduce flexibility for such schemes for example, on revaluation and indexation which currently does not exist? Do you think the model outlined is the right model?

Alternatively, is there already sufficient flexibility for innovative approaches to risk sharing?

1.3.1 Responses received

Here the responses divided into three relatively distinct areas. First, the majority of those who responded including the NAPF, SPC, PMI, Prudential and the EEF expressed scepticism about the idea of a third layer of legislation for risk sharing schemes. There was general recognition that there was some scope within existing legislation for some forms of risk sharing schemes, and that legislating for a particular kind of scheme would limit the scope for different approaches.

While most rejected a wholly new regime, many hoped that the existing regime could be amended or relaxed in certain areas to allow more risk sharing approaches. Some consultation responses in particular argued for specific changes in relation to cash balance schemes. These included a proposal that cash balance schemes should not be subject to mandatory indexation of pensions in payment. Many respondents, including CBI and TUC, offered to work with Government in continuing to scope out the potential for change to encourage more risk sharing approaches.

The third area of comment related to an emerging view from a number of employer-related organisations that one particular proposal would make a radical difference to risk sharing possibilities: conditional indexation. Indexation would be targeted, and employers would be required to fund prudently with the intention of providing indexation. However, the provision would be conditional on the actual level of funding in the scheme. In the event of a deficit in any given year, schemes would be able to forego indexation for that year. If there was a funding surplus in following years, the first call should be upon restoring lost indexation rights. Some suggested that this approach should be ring-fenced and only applied to new, risk sharing schemes, however defined; others argued that this approach should be opened up to all existing schemes, citing experience in the Netherlands.

1.3.2 Action

The Government is already committed to working with the Pension Protection Fund on their treatment of risk sharing schemes, and will together with the Pensions Regulator consider the scope for sharing information about the various types of risk

sharing schemes currently in existence. Such information would highlight what might be possible under current legislation.

In view of the consultation responses, the Government also proposes to work with stakeholders to explore urgently the potential and practical implications of the ideas set out above, for Government, employers and scheme members. In particular, it will be important to explore a number of issues including conditional indexation, but the Government is concerned that it would introduce practical complexities and moral hazard issues, and, as employers would still be expected to fund in expectation of providing indexation, the Government is unsure if it would provide employers with sufficient incentives to continue to provide defined benefit arrangements. The Government therefore remains to be convinced about conditional indexation.

The Government recognises that some commentators would have preferred even more urgent action, including measures in the forthcoming Bill at Introduction. The changes proposed could have far-reaching consequences for occupational pension provision and, as was acknowledged by several respondents, need to be worked through in detail before legislation can be contemplated.

2 Other issues raised

While not part of the formal consultation, various other issues were raised by respondents.

2.1 Limited price indexation of pensions in payment

Government position as outlined in Response document

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. Subject to what is said above about exploring the suggestion of introducing provision for conditional indexation, the Government has therefore decided not to make any changes to the current requirements.

Responses received

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.

2.2 Accrued rights

Government position

No regulatory changes should be made which would adversely affect the position of pensioners or deferred pensioners at the present time or the past-service rights at the present time of active staff.

Responses

Where this issue was raised, the Government's position met with approval among respondents.

2.3 Surplus

Government position

The Government did not agree with the reviewers' recommendation that a return of scheme funds to the employer should, with trustees' agreement, be available once the scheme specific funding target is reached. The Government's view is that such a change could significantly jeopardise the current level of protection for scheme members.

The Government also said that it was minded to remove the specific legislative requirement for trustees to be satisfied that any return of surplus is in the members' interests, if it could find a way to do so without weakening the trustees' common law fiduciary duties.

Responses

Some respondents - mostly actuaries and employers - felt that the requirements around surplus are too onerous and could discourage some employers from agreeing to sufficiently prudent funding objectives for their scheme. They felt that improving employers' access to surplus funds, should they arise, would encourage employers to more willingly agree to stronger scheme funding targets. They urged the Government to find a practical solution to address such concerns.

Others, notably the TUC, felt that the ownership of surplus was not straightforward and that, in some cases, the first call on any excess funds should be, for example, to restore any member benefits under the scheme where these have previously been reduced.

Action

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.

2.4 Pension sharing

Government position

There are concerns about the complexity of the requirements and the different treatment of pension credit rights. The Government agreed 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.

Responses

The Government's proposals in this area were warmly welcomed by all the correspondents who raised the issue.

Action

The abolition of safeguarded rights will be taken forward in the Pensions Bill. DWP will begin looking at the other aspects of pension sharing legislation, in consultation with stakeholders, in the first half of 2008.

2.5 Trustee knowledge and understanding

Government position

The Government rejected the reviewers' recommendation to amend the legislation on trustee knowledge and understanding, while accepting that there may be widespread misconceptions about the burdens imposed by the existing requirements. The Government also rejected the reviewers' recommendations on overriding legislation on trustee legal expenses and on personal liability issues.

Responses

Here also there was a high level of agreement. The CBI commented, however, that the Government should put in place sufficiently clear guidance for trustees, although they felt that the legislation is less restrictive than the employers operating some schemes believe.

Action

The Government will be discussing with the Pensions Regulator what clarification can be offered to trustees and trustee boards.

2.6 Trivial commutation

Government position

At the 2006 Pre-Budget Report, in response to pensions industry concerns over administration of trivial commutation, the Government announced that HM Revenue and Customs (HMRC) would discuss with interested parties the administration of the trivial commutation rules. These discussions are ongoing.

Responses

The discussions have been constructive and have identified a range of opinions on the matter. One respondent pointed out the risks of satisfying a contributor's short term interests at the expense of the longer term, and another that the main difficulty from 6 April 2006 has been aggregating benefits in order to decide whether a member's rights are less than 1% of the lifetime allowance. They felt this should not apply where a member has not been an active member at any time on or after 6 April 2006.

Action

The consultation responses have been shared with HMRC, who will consider them as part of their ongoing discussions on the issue.

2.7 Employer debt

Government position

The Government has already accepted the first of the reviewers' recommendations and has consulted on draft amending regulations which (among other proposed changes aimed at addressing concerns around the existing legislation) allow a twelve month period of grace before the triggering of a cessation event. The Government is now considering responses to that consultation.

The Government accepts that the current provisions create difficulties for employers who wish to undertake a company reorganisation and wants to try to resolve them.

However, this is a difficult area and it may not be easy to find a way to address this without creating loopholes within legislation.

Responses

The Government's intention to continue looking at this area was generally welcomed.

The Association of Pensions Lawyers commented that they agreed that the triggers leading to a statutory debt on an employer do not always reflect the policy intent and that consideration of this area would best take place as part of a wider review - it was difficult to find a 'one size fits all' approach here. The TUC believed that the current position where a debt is triggered unless the trustees and the Regulator approve an alternative withdrawal arrangement is right and should continue, but others commented that it was excessively burdensome. CBI proposed that corporate restructurings should be excluded from the provisions of section 75 of the Pensions Act 1995 altogether, and particularly where the employer's covenant has not weakened following the change.

Action

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 difficulties created by the current provisions which does not undermine the principle that employers should fully meet their pension obligations. It will be necessary to scope the work and involve interested stakeholders. The Government will start to take this work forward in the New Year.

Meanwhile, amendments to the current regulations (following consultation referred to above) are planned shortly.

2.8 Principles based legislation

Government comments

The Government agreed, in principle, to the reviewers' recommendations for a more framework based approach to legislation. The reviewers recommended that the current disclosure regime be replaced with a framework of outcome-related principles accompanied by guidance, and the Government is encouraged by the fact that stakeholders agree that disclosure would be the right place to start.

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.

Responses

There was widespread support for this. Disappointment was expressed by some respondents that the principles based approach was to be confined to the disclosure regulations arising out of the provisions in section 113 of the Pension Schemes Act 1993 and some felt that the examination of the disclosure requirements could go further. A particular concern was that instead of reducing the volume of legislation the detail of the legislation might just be transferred to codes of practice which have the force of regulations.

Not all were in favour. The Occupational Pensioners Alliance commented that a principles based approach would make it more difficult to challenge the actions of a pension scheme.

Action

A Working Group comprising key stakeholders has been set up and has met to agree the broad parameters for the work. In addition members of the group were asked to provide thoughts on what the principles should be, and areas where a principle based approach may not be appropriate. The next meeting of the group is in January.

The aim is to report to Ministers by summer 2008. There would then be wide consultation on any proposed changes. The aim is to have new legislation in force by April 2010

Annex A

Organisations and individuals that responded to the consultation

Adrian De Segundo
Adrian Read
AEGON
Albert Edwards
Aon Consulting
Arc Benefits Limited
Association of British Insurers
Association of Consulting Actuaries
Association of Pension Lawyers (two separate submissions)
CBI
Connect
CWU
David Baggley
David Evans
David Rees
Derek Benstead
Electricity Pensions Services Limited
Engineering Employers Federation
Eversheds
Fidelity International
First Actuarial
GMB
Graeme Brown
Hewitt, Bacon & Woodrow
Joel Kosminsky
John McLeod
Keith Dodwell
Ken MacIntyre
Malcolm B Fox
Mark Davies
Martin Whapshott
Mayer Brown International LLP
Michael Hart
Mike Aldous
National Association of Pension Funds
NTL Pension Association
Occupational Pensioners' Alliance
Occupational Pensions Joint Working Group
Pensions Management Institute
Pete Southgate
Peter Neville
Phillip Cleary

Prospect
Prudential
Punter Southall
Richard Adam
Scott R Coghill
SPC
Standard Life
Tesco
The Actuarial Profession
The British Chambers of Commerce
The Co-operative Group
The Hundred Group
The Institute of Chartered Accountants in England and Wales
The trustee company of the Plumbing and Mechanical Services (UK) Pension Scheme
Tony Butcher
Travers Smith
TUC
Watson Wyatt

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