



## Guidance

# Defined benefit pension schemes: questions and answers

These questions and answers explain some of the terminology used in relation to pension arrangements, the role of the Pensions Regulator and provide answers to the questions that trustees most frequently ask us.

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## Introduction

In recent years a number of charity pension schemes have reported significant deficits. This is because the value of scheme assets has fallen at the same time as a combination of increased longevity of scheme members, low interest rates and lower than expected returns have contributed to a rise in the value of scheme liabilities. Pension legislation also affects how existing pension arrangements can be restructured, and affects charities' restructuring through incorporation or merger.

Careful planning and advice in relation to any proposed restructuring of a charity, such as on incorporation or merger, is now likely to be necessary to avoid large cash outflows.

The Pensions Regulator has published guidance for employers (including charities) that sponsor pension schemes about the potential problems they may face in funding these schemes in times of economic difficulty.

Our guidance [Charity Reserves and Defined Benefit Pension Funds](#) explains the risks attached to a charity's involvement in a defined benefit pension scheme for its staff. It also looks at the accounting implication of membership of the scheme, the role of the various regulators and the potential liabilities for trustees.

### 1. What is a defined benefit pension scheme?

The most common form of defined benefit pension scheme is also known as a final salary pension scheme. Under these schemes employee members are entitled to a particular level of benefit depending on their length of service and the level of their salary when they retire.

In a defined benefit pension scheme the pension benefit is defined by a formula linked to the member's earnings and/or the length of their pensionable service. Those managing the scheme need to ensure that the contributions from both the employer and the employee are sufficient to provide the aggregate pension benefit.

A significant number of charities have set up defined benefit pension schemes for their employees. In doing so, the trustees of the charity will have taken a decision that the scheme in question is in the interests of the charity. This may be for a number of reasons such as the need:

- to attract and keep staff of an appropriate calibre; or
- to offer similar terms and conditions to other employers in the same field.

### 2. What is a defined contribution pension scheme?

A defined contribution pension scheme is known as a money purchase scheme. These are pension schemes into which an employer pays a regular contribution fixed as an amount or percentage of the employee member's pay. The employee may also make contributions into the scheme. Benefits are determined according to the:

- contributions paid into the scheme;
- investment return on those contributions; and
- cost of purchasing an annuity at retirement.

There is no requirement for employers to make further contributions regardless of the performance of the assets.

Some employers prefer to run a defined contribution pension scheme rather than a defined benefit scheme, as it is usually less costly to them and results in a predictable cash outflow. In a defined contribution scheme the level of benefit depends on the contributions made, rather than contributions needing to catch up with the actual benefits as in the case of defined benefit schemes.

### 3. What are employers' legal obligations for providing pension schemes?

Where employers do not have either a defined benefit or defined contribution scheme the current legal requirement is that, if they employ five or more people, they must provide access to a stakeholder scheme, organised by the employer. Employers do not have to make contributions to the scheme, but they must arrange for payroll deductions of the employee's contribution, if they are asked to. Employees may choose to opt in to the scheme if they wish. This will change in 2012 (see question 4).

### 4. How will the employers' legal obligations change in 2012?

The Pensions Acts of 2007 and 2008 brought in new obligations for all employers, including charities. From 2012 onwards employers will have to automatically enrol all eligible workers into either a good quality workplace scheme or the government's National Employment Savings Trust (NEST), a trust-based occupational pension scheme. Workers will have to opt out of these schemes if they do not wish to take part, rather than opt in as they do with the current stakeholder scheme arrangements.

Employers will have to contribute to the scheme at least 3 per cent of the worker's earnings between £5,035 and £33,540, although they can pay more if they wish. The worker will also contribute a minimum of 5 per cent of his or her earnings, of which 1 per cent will come in the form of tax relief. To help employers adjust gradually the plan is to phase in the employer contribution levels: starting at 1 per cent and then moving to 2 per cent and finally 3 per cent. The worker's contributions will also be phased in the same period.

The Pensions Regulator will give each employer a staging date from which the changes will have to be in place. The first staging dates will start in October 2012 and will continue through to 2016. The staging date will be based on the number of workers an employer has. Those with the largest number of workers will have the earliest staging dates. The smallest employers will have the last staging dates in 2016. The Pensions Regulator will write individually to employers between 6 and 12 months before the staging date to inform them when they need to take action and what they need to do.

For further details of the changes see The Pensions Regulator's [website](#) and DWP's [website](#).

### 5. What is Financial Reporting Standard 17?

FRS17 is an accounting standard, issued by the Accounting Standards Board, that sets out the accounting requirements for entities, including charities, that operate pension schemes. It mainly affects those charities operating defined benefit schemes; those operating contribution schemes are not significantly affected by this accounting standard.

Those entities with a defined benefit scheme have to calculate their pension costs and make significant disclosures about their schemes. FRS 17 has no direct impact on the cashflow of a defined benefit scheme, but it does bring greater transparency to accounting for retirement benefits, and brings into sharp focus the costs and risks associated with defined benefit pension provision.

Further guidance on how charities should account for pension schemes is provided in the [Charities SORP](#).

## 6. Who Regulates Pension Schemes?

The [Pensions Regulator](#) is the regulatory body for work-based pension schemes in the UK. A work-based pension scheme is any scheme that an employer makes available to employees. This includes all occupational schemes and any stakeholder and personal pension schemes where employees have direct payment arrangements, ie they make a contribution to the scheme via a deduction from their pay.

The Pensions Act 2004 gave the Pensions Regulator a set of specific objectives:

- to protect the benefits of members of work-based pension schemes;
- to reduce the risk of situations arising that may lead to claims for compensation from the [Pension Protection Fund](#); and
- to promote good administration of work-based pension schemes.

It also provides practical guidance for trustees, employers (including charities), administrators and others on complying with the requirements of pension law.

The Pensions Act 2008 introduced another objective for the Pensions Regulator. The government's pensions reform aims to make sure that more people have adequate and well-protected savings. The 2008 Act introduced new duties on employers, including auto enrolment, and gave the Pensions Regulator a new objective to maximise compliance with the duties, and ensure safeguards that protect employees are adhered to. The [Pensions Regulator website](#) contains more details on pensions reform.

## 7. What are the funding requirements for defined benefit pension schemes?

Most defined benefit pension schemes need to meet a statutory funding objective, known as technical provisions, which assesses the required levels of funding a scheme requires to provide benefits for its members. Employers need to work closely with the trustees of the pension scheme to agree what the technical provisions for the scheme should be and set out a schedule of contributions to meet and maintain this level. Regular valuations, at least every three years, are required to check whether the statutory funding objective is met; where it is not, trustees and employers will need to agree on a recovery plan.

Employers and scheme trustees should obtain advice separately from appropriate professionals, such as actuaries and lawyers, to inform their decision making.

The [Pensions Regulator](#) has issued a code of practice on funding defined benefits.

## 8. What is the situation with defined benefit pension schemes that are in deficit?

A large proportion of many final salary pension funds are held in equities and face deficits in periods of significant falls in the value of stock markets. The Pensions Regulator studies pension funds' triennial valuations and can require any employer whose fund is in deficit to take action to rectify the situation.

Where the statutory funding objective is not met resulting in a deficit in the pension fund, the employer and pension scheme trustee have to agree a recovery plan setting out the steps to be taken to put things right.

## 9. What is the Pensions Regulator doing to help employers in the current economic recession?

The Pensions Regulator has published a statement emphasising the importance of prudent funding levels for pension schemes and stating that where sponsors are in difficulty, flexibility is available in recovery plans. The statement, '[Scheme funding and the employer covenant – prudence, affordability, applying flexibility through the economic cycle](#)', can be viewed in full on their website.

The statement sets out that while economic and financial conditions have resulted in short-term cash constraints for some employers and greater long-term uncertainty for others, the Pension Regulator's current regulatory framework and approach to scheme funding is flexible.

The purpose of the framework is to secure member benefits for the long-term and to enable employers to play their part in the economic recovery. The approach to scheme funding aims to achieve this with a sufficiently prudent funding target resulting in a recovery plan to repair the deficit in the scheme which is reasonably affordable for the employer.

This statement builds on an [earlier communication in February 2009](#) when the Pensions Regulator issued a statement to employers who sponsor defined benefit pension schemes recognising that economic conditions are of real concern to employers. The statement aimed to reassure employers that the current scheme funding regime is flexible enough to cope with the economic recession. In particular it highlighted that:

- where a sponsor company is under pressure there is potential to renegotiate previously agreed plans to repair pension deficits;
- trustees of pension schemes in deficit are unsecured creditors of their sponsor employer. Trustees should be in a position to understand what is reasonably affordable for their sponsor employers, but all unsecured creditors must be treated equitably and the pension scheme not disadvantaged.

Any employer who believes that an existing recovery plan is at serious risk of jeopardising the employer's future health or solvency should discuss this with their pension scheme trustees and talk to the Pensions Regulator if they have concerns. The scheme trustee and sponsor employer must inform the Pensions Regulator of proposed revisions to the recovery plan. The Pensions Regulator has undertaken to continue to apply the flexibilities in the scheme funding system pragmatically, looking for outcomes in the best interests of the scheme and sponsor employer.

## 10. Does the Charity Commission produce any guidance for charities regarding pension schemes?

The [Pensions Regulator](#) is the regulator of all work-based pension schemes in the UK. It provides practical guidance for trustees, employers (including charities), administrators and others on complying with the requirements of pension law.

The Commission does not publish separate guidance on the application of pension law as it applies no differently to charities than to other entities. We do however provide guidance on particular issues that impact on the charity reporting framework. Recommendations on accounting for pension and other retirement benefits are contained within the [Charities SORP](#).

The Commission has also produced guidance on [Charity Reserves and Defined Benefit Schemes](#) explaining how a charity's reserves policy might address pension deficits. The guidance also contained information about the possible liabilities of charity trustees.

## 11. What is the Pension Protection Fund?

The [Pensions Act 2004](#) introduced the [Pension Protection Fund \(PPF\)](#). The PPF exists to provide compensation to members of schemes where the employer becomes insolvent and the scheme has insufficient funds to provide at least the same levels of benefit as the PPF to its members. The PPF is funded in part by existing pension schemes which pay a yearly levy, part of which depends on their risk profile.

Further information about the role of the Pension Protection Fund, the levy and how it is calculated can be accessed from its [website](#).

## 12. Can charity assets be charged to reduce levy contributions?

An issue that has arisen for charities is how to reduce the risk profile of any pension scheme which they operate and consequently the amount of the levy. One way of doing this is to put in place a contingent asset, which can reduce the risk that an insolvency event results in a claim on the PPF, or reduce the size of a claim if one occurs, provided they satisfy the requirements of the determination and have been certified correctly and on time.

For a charity a contingent asset could involve securing the liabilities of the scheme on the assets of the charity. This may involve charging charity land in which case the charity trustees will need to comply with section 38 of the Charities Act 1993.

In particular, an order of the Commission under section 38 is not required if the charity trustees have, before entering into the charge, obtained and considered proper advice, given in writing, on whether it is reasonable for them to undertake to discharge the obligation, having regard to the charity's purposes.

To be recognised in the pension protection levy calculation, contingent assets must satisfy the PPF's requirements and be certified correctly and on time. More information can be found on the [PPF's website](#).

## 13. What issues arise for an unincorporated charity considering incorporation?

Incorporation usually results in the winding up of an unincorporated charity and the creation of a new separate charitable legal entity to which the assets of the unincorporated charity will be transferred. Where the unincorporated charity sponsored a defined benefit scheme it will cease to be the sponsor.

Where the scheme is a multi-employer scheme this will be a cessation event (see question 16).

Where the scheme is a single employer pension scheme, the transfer of the undertaking to a company preserving the rights of employees under the pension scheme could crystallise the full buy-out value of the scheme. In most cases parties will seek to avoid this by the newly incorporated charity agreeing to act as sponsor to the scheme. Trustees may question whether the covenant (the legal obligation and ability to meet payments to the scheme, including on insolvency) has changed on this transfer and whether mitigation is needed for any detriment. Where the new organisation has no track record it can help to explain how the new organisation has come into being.

If the transaction is materially detrimental or was entered into for the purpose of avoiding the pension scheme debt the Pensions Regulator has powers to take action.

There is a clearance procedure, established by the Pensions Act 2004, which allows an application to be made to the Pensions Regulator to obtain assurance that the Pensions Regulator will not use its powers in relation to the transaction after it has gone ahead. Further guidance on making a clearance application is available on the [Pension Regulator's website](#).

#### 14. Can similar issues arise when two or more charities merge?

Yes, a merger may often result in the creation of a new separate charitable legal entity and/or the winding up and removal of an existing charity. There are similar issues to be considered as with incorporation.

#### 15. Does the Charity Commission have any role to play in these cases?

The Commission is able to advise on the charity law aspects of incorporation or merger but is unlikely to need to be involved in obtaining clearance in relation to pension arrangements unless some action is required on the part of either the unincorporated charity, the new incorporated charity or in the case of a merger, the successor charity which might otherwise not be within the powers of the charity. In such circumstances, if the Commission is satisfied that the proposed action is expedient in the interests of the charity, it may be able to authorise the charity to take the action. In the context of incorporation, there have been issues about additional liabilities arising in respect of the pension scheme and charity trustees being concerned as to how reasonable it is for them to take on such liabilities.

Similar issues may also arise in the context of mergers or other transfers of staff, activities and assets on the winding up of a charity.

#### 16. What are the issues with regard to multi-employer pension schemes?

Changes to the law on multi employer pension schemes were brought in by Statutory Instrument in 2008 ([The Occupational Pension Schemes \(Employer Debt and Miscellaneous Amendments\) Regulations 2008](#)).

A number of charities have established defined benefit multi-employer pension scheme for their respective employees. This may be more viable than each charity establishing its own scheme. In multi-employer schemes additional liabilities can become payable if an employment-cessation event occurs. An employment-cessation event occurs at the time an employer ceases to employ at least one person who is an active member while at least one other employer continues to employ active members.

However there is a period of grace which is designed to prevent employers with a small number of employees and scheme members from inadvertently triggering a debt when they intend to enroll more members in the scheme. An employer can be treated for a 12 month period as if it employed a person who is an active member of the scheme, if they notify trustees that they intend to employ someone in the next 12 months who will join the scheme. If at the end of the 12 month period the employer still has no active members a cessation event will be deemed to have occurred as at the date that the employer's last active member left.

When an employer ceases to participate in a multi-employer scheme, their share of the liabilities – including any orphan liabilities (benefits in the scheme which are not related to any current sponsoring employer) will be calculated on a buy-out basis. In most cases it will not be necessary to pay this liability in full at the time. It will instead be modified in one of four ways depending on the circumstances, subject to the agreement of the parties involved.

Full details of these arrangements are in the Pensions Regulator's guidance for employers, scheme trustees and advisers '[Multi-employer withdrawal arrangements](#)', which can be downloaded from its website.

## **17. Does the Charity Commission have any powers which would be of assistance in these circumstances?**

The Charity Commission recognises the seriousness of the issues confronting the sector in respect of defined benefit pension schemes. It would wish to assist in identifying good practice and facilitating this to the extent it is able to do so.

As has been indicated, the Commission can authorise charity trustees to take certain actions which may not otherwise be within their powers. Where trustees are concerned that they may be exceeding their powers, they can apply to the Commission for advice under section 29 of the 1993 Act or for an order under section 26.