Department for Work & Pensions

Draft regulations to allow the Pension Protection Fund to take account of bridging pensions

Government Response

January 2018

Contents

Executive summary

The Department for Work and Pensions consulted on changes to legislation so that the Pension Protection Fund (PPF) compensation payable in respect of a step-down pension (referred to in the consultation as a bridging pension) takes account of the reduction that would have occurred in the rate of the pension under the original scheme.

Step-down pensions are a feature of some defined benefit, occupational pension schemes and pay an initial, high rate of pension which later reduces, from a date specified in the scheme rules, usually from state pension age (SPA) (the decrease date).

The term 'bridging pension' was used in the consultations and draft regulations to refer to the overall pension, including both the initial high rate and subsequent reduced rate. However, responses to the consultation indicated that this term is generally used to refer to the temporary additional element of the pension which is paid on top of the basic lifetime amount, from retirement until the decrease date. Therefore, for the purposes of this document and in the regulations the term "step-down pension" is used to describe this type of pension arrangement and "bridging element" to describe the additional amount that ceases to be paid at the decrease date.

Currently, pensioner members in receipt of a step-down pension at the higher rate when their scheme enters PPF assessment receive PPF compensation based on this higher rate for life. Had the pension scheme not entered the PPF, the member's scheme pension payments would have reduced at the decrease date. For some members this means that they may be financially better off in the PPF than they would have been under the rules of their scheme.

Between 31 August and 1 October 2017, the Department consulted on draft regulations to address this anomaly by actuarially converting the step-down pension into a notional flat-rate, lifetime-equivalent amount, and basing compensation on that notional pension (the "smoothing approach"). The consultation also outlined an alternative approach of moving members to a lower rate of compensation after they reach the decrease date (the "scheme rules based approach").

In total we received 28 responses from a mixture of individuals, trade bodies and pension professionals. In addition, we held two focus groups during the consultation period; one with consumer groups and the other with pension scheme administrators and industry experts.

The vast majority of those who responded to the consultation agreed that the Government should legislate to correct the anomaly in the PPF treatment of step-down pensions. However, a significant proportion of respondents expressed a preference for the scheme rules based approach, as did the consultation focus groups. The most common reason given was that the immediate drop in income for pensioners on the high rate of their step-down pension, inherent in the smoothing approach, could result in personal financial hardship, particularly where the bridging element was a high proportion of the member's overall pension.

After careful consideration of the responses to the August consultation, the Government decided to adopt the scheme rules based approach and subsequently ran a technical consultation on revised draft regulations to implement this approach. This consultation ran from 17 November to 3 December 2017 and a total of 10 responses where received, again from a mixture of individuals, trade bodies and pension professionals.

This document sets out the Government's response to the comments received in relation to the questions asked in both the August and November consultations.

Annexes A and B list those who responded to the consultations, and the Government is grateful to them for sharing their views and comments on the draft regulations and the merits of two approaches.

Chapter 1: The Pension Protection Fund and step-down pensions

The Pension Protection Fund (PPF) was established by the Pensions Act 2004. It provides compensation to members of DB occupational pension schemes where the sponsoring employer has suffered a qualifying insolvency event on or after 6 April 2005 and the funds in the scheme are insufficient to buy annuities that would pay pensions at, as a minimum, PPF compensation levels.

Some DB occupational pension schemes include step-down pensions[1]. Broadly speaking, these allow members of such schemes who retire before reaching SPA to be paid a higher rate of pension until they reach a date specified in the pension scheme rules, usually SPA (the decrease date). The pension then reduces (or 'steps down') to reflect the fact that the member is now in receipt of their state pension. Effectively, the scheme bridges the gap between the date the member retires and SPA.

The exact date the pension steps down can vary from scheme to scheme and may not always be the date that the member begins to receive their state pension.

Under current legislation, PPF compensation payments do not generally take account of scheduled changes to pension entitlement after the date on which the member becomes entitled to compensation (the assessment date, in the case of members already in receipt of their pension). Therefore, members in receipt of the high rate of a step-down pension immediately before their scheme's PPF assessment period starts, currently receive PPF compensation based on this rate for

[1] The step-down pension may be one of a range of payment arrangements offered to members taking their benefits or it may be the default or only option.

life. Similarly, in those cases where a step down pension is the default or only pension arrangement offered under the scheme (rather than an option)[2], deferred (and in some cases active) members' PPF compensation would currently be based on the high rate for life.

[2] PPF does not offer members the option to take their compensation in a step down structure so whereas a member may have had a range of options on taking their benefits under the original scheme rules, the PPF will calculate their compensation based on the standard, single rate option.

Chapter 2: Consideration of legislative changes to implement the smoothing approach

The August consultation sought views on draft regulations to address the anomaly in the PPF treatment of step-down pensions by actuarially converting step-down pensions into a flat-rate, lifetime-equivalent amount (the smoothing approach).

The Government asked:

Question 1: Do you have any evidence on how many schemes offer bridging pensions[3] as part of their defined benefit pension scheme? Are bridging pensions typically offered as an option where scheme members opt in to take their benefits in this way, or as an automatic right?

Question 2: Do you agree that the smoothing approach is an appropriate way to deal with an individual's bridging pension under the PPF?

Question 3: Are you aware of any potential unintended consequences, for individuals or scheme administrators of smoothing PPF member's compensation amounts in future?

Question 4: What administrative tasks would need to be undertaken by schemes or sponsoring employers to provide PPF with the additional information needed to reflect step downs? We would also be interested in any evidence that schemes or sponsoring employers can provide on the estimated cost of providing this additional information as well as estimated costs incurred through any additional actuarial calculations.

Question 5: Would schemes or sponsoring employers incur any other direct or indirect costs associated with the proposed change?

Question 6: The regulations as currently drafted do not cover active members as the PPF already has the discretion to calculate compensation for this group. We believe

[3] Bridging pensions was the term used in the original consultation and has been retained here for the purposes of these questions.

that this is sufficient to deal with bridging pensions for active members, but would welcome respondent views on this matter, and any evidence that they can provide on how active members' accrual rates are defined in scheme rules where there is an automatic right to a bridging pension.

Question 7: If the Government were to proceed with the smoothing approach, do you agree that the regulations as currently drafted meet the policy intent? And if not we would welcome evidence or comments on the changes required.

Question 8: Do the regulations as currently drafted enable PPF compensation to reflect all bridging pension arrangements that you are aware of?

Government response

The Government received 28 responses to the August consultation. Of these, 17 respondents expressed an opinion on whether Government should address the anomaly in the PPF treatment of step-down pensions and 13 out of those 17 respondents (over 75%) agreed that Government should legislate to correct it.

Of the 28 respondents, 24 expressed an opinion on the merits of the two implementation approaches. Of those, 16 respondents (over 60%) expressed concerns about the smoothing approach, and most expressed a preference for the scheme rules based approach.

While it was understood that, under the smoothing approach, pensioner members would experience an initial reduction in income, the actuarial adjustments were intended to ensure that, overall, members would not be worse off over their assumed lifetime. However, the consultation responses highlighted that the bridging element may represent a significant proportion of a member's overall pension, and by smoothing the total amount, affected members could receive significantly less in PPF compensation during the bridging period than they would have done under their original pension scheme. Members who had factored the initial higher payments into their financial plans could find it difficult to plug the income gap following the initial reduction on entering the PPF assessment period. This could cause hardship if members experienced difficulties in meeting financial commitments until they start receiving the state pension.

A small proportion of respondents were of the view that this would disproportionately affect those on lower incomes as it is likely that this group would rely more on the bridging element amount to support them and have limited options in finding alternative sources of income.

Other reasons for preferring the scheme rules based approach were:

- a member who dies earlier than expected would lose out disproportionately under the smoothing approach;
- the PPF would have to readjust actuarial calculations with changing life expectancies;

- potential under and overpayments during the PPF assessment period; and
- difficulties in communicating to members the actuarial adjustments inherent in smoothing which may result in increased contact, putting an additional administrative burden on trustees and scheme administrators.

Following careful consideration of all the responses and information received, the Government decided to adopt the scheme rules based approach to address the anomaly in the PPF treatment of step-down pensions so that PPF compensation for members with this type of pension more closely reflects, in this respect, the rules of the original scheme.

Step-ups and Guaranteed Minimum Pensions

The majority of salary-related pension schemes were "contracted-out" of the additional State Pension before contracting out ended in April 2016.

The additional State Pension (or State Earnings Related Pension – SERPS), an earnings-related element of the old State Pension, was introduced in April 1978. Employers operating occupational salary-related (or defined benefit) pension schemes could "contract-out" of the additional State Pension provided the scheme paid its members a pension of at least a statutory minimum known as the "Guaranteed Minimum Pension" (GMP). In return both the member and the employer benefitted from national insurance rebates. The GMP is effectively provided in place of the additional State Pension.

Schemes that were contracted-out between 1978 and 1997 must comply with the GMP rules[4] and provide a pension at least equal to the GMP at age 65 for men and 60 for women. This can add a further scheduled change for the member, after the date the scheme enters PPF assessment.

The Government asked two questions related to this issue:

Question 9: Do you have any views how many people are affected by the issue of GMPs and PPF compensation?

Question 10: Do you think that PPF compensation should take account of increases in the member's scheme pension which would have taken place at GMP age (60/65) in respect of the GMP requirements in future? If so, we would welcome evidence for your views.

Of the 28 consultation respondents, 12 answered the questions 9 and 10. Of these, 10 felt that the Government should address the matter of "GMP step ups" where the increase for which some PPF members may have been eligible under the rules of their original scheme is not reflected in their PPF compensation.

Although the Government recognises the points raised, this is a complex area and we are discussing with the PPF how best to gather the data necessary to help us better understand the scope, nature and extent of the problem. The Government also

[4] GMP rules are provided under section 13-17 of the Pension Schemes Act 1993.

thinks it prudent to allow the changes made in respect of step-down pensions to bed in fully before seeking to introduce further changes in relation to step-ups and GMPs.

Further consideration will be given to addressing this issue once our enquiries are complete.

Chapter 3: Consideration of legislative changes to implement the scheme rules based approach

Following the change in approach, the Government consulted on revised draft regulations to implement the scheme rules based approach from 17 November to 3 December 2017.

The Government asked:

Question 1: Do the draft regulations achieve the policy intent as outlined in this consultation document?

Question 2: Are you aware of any unintended consequences resulting from the draft regulations?

Government response

We received 10 responses to this consultation, five of which commented on the regulations. In addition to the changes made as a result of this feedback, some minor technical changes have been made to ensure the regulations are clear and operate as intended. The relevant changes made to the regulations are set out below.

The Government would like to thank all the respondents for their assistance in refining the regulations to ensure they have the intended effect.

"Bridging pension" – terminology and definition

A number of respondents suggested that the use of the term 'bridging pension' in the regulations was potentially confusing. This term is widely used in industry to refer only to the initial, temporary additional amount that a member receives on top of their main lifetime pension entitlement ("the bridging element"). For clarity, we have amended the regulations so that this type of pension arrangement is now referred to as a 'step-down pension'.

One respondent stated that the definition of a step-down pension used in the draft regulations was too wide and the regulations should be amended so that it is clear that they only apply to a step-down pension arrangement. Some examples were provided of other circumstances that, it was suggested, could potentially fall within the definition in the draft regulations, for example, an ill-health pension may reduce should the member recover and no longer fulfil the ill-health definition.

The Government has carefully considered this point and has decided that it is not necessary to amend the definition of a step-down pension. The regulations refer to a pension rate which would have decreased at a future date – that is, where it is known on the PPF assessment date that a decrease will occur. In the scenarios provided by the respondent, the decrease would occur as a result of a change in the member's circumstances rather than as an expected feature of the pension. However, as with all policy, we will keep this area under review as the changes bed in.

Payment of compensation beyond the death of member or survivor

It was pointed out that under the draft regulations, should a member or survivor die before reaching the date that the bridging element of their compensation was due to cease, they would still technically be eligible to receive this compensation past their death until they were originally due to step down. This is an unintended consequence and we have amended the regulations to make clear that compensation in respect of the bridging element does not continue past a member's or survivor's death.

Late retirement

The draft regulations consulted on provision for members who delay receiving compensation until after their normal pension age (NPA) to receive actuarially increased compensation, including in respect of the bridging element. However, a respondent identified that, in some cases, this could result in an inadvertent breach of tax rules which limit the reductions that can be made to a member's pension, and potentially give rise to an 'unauthorised payment' charge.

We have considered this point and concluded that the respondent has identified an unintended consequence, in that the approach outlined in the November consultation would give rise to this risk. We have therefore amended the draft regulations so that they no longer provide for the application of a late retirement increase in respect of the bridging element. Members who opt to retire late will receive the bridging element from their retirement date to the decrease date, and an actuarial increase only in respect of the lifetime element of their pension. We understand that this approach is in line with the practice in schemes more generally.

Survivors of members who die before reaching NPA and who have opted to take their compensation early

The draft regulations provided that the surviving spouse or civil/relevant partner of a member who died before reaching NPA would receive compensation in respect of the bridging element for the same length of time that the member would have received it if their compensation began to be paid at NPA. However, a respondent highlighted that the draft regulations did not make specific provision for the situation where the member had chosen to receive compensation early at an actuarially reduced rate, and would therefore have received it for a longer period. This has been corrected and the draft regulations now provide the survivor of such a member to be paid compensation in respect of the bridging element for the period from the member's death until the decrease date, to take account of the actuarial reduction in the rate of compensation payable.

The PPF compensation cap

One respondent suggested that the bridging element should be disregarded for the purposes of applying the PPF compensation cap as the state pension is not taken into account when determining the cap. We did not consider that it was appropriate to disapply the cap in these circumstances. The state pension is not relevant to the calculation of PPF compensation and, in any event, the amount of the bridging element does not necessarily reflect the actual amount state pension in payment. The cap is important in controlling the costs of the PPF and we do not believe that there is a persuasive case for not including the bridging element when calculating the total amount of compensation to be capped.

In addition, disregarding the bridging element for the purposes of the cap could result in two members with the same lifetime value of benefits under a scheme being treated differently, where one had opted for a step-down pension and the other for a single rate pension. If their level of benefits was around the level of the cap, the person with the single rate pension could be capped even if the one with the step-down pension would not.

Chapter 4: Next Steps

The changes to PPF compensation rules for those with a step-down pension will come into effect in February 2018, subject to Parliamentary procedures. Any scheme entering PPF assessment on or after the date the regulations come into force will be subject to the new compensation rules. There will be no impact on members of those schemes which entered the PPF before the regulations come into force.

Annex A: List of Responses from Organisations to our August Consultation

Mr Arthur Andrews

Mr Graham Andrews

Association of Consulting Actuaries

The Association of Member Nominated Trustees

Aon Hewitt

Association of Pension Lawyers

British Steel Pension Fund member (name not supplied)

British Steel Pension Fund Trustee Limited

Mr Mike Close

Mr Martin Edwards

Eversheds Sutherland

First Actuarial

Institute and Faculty of Actuaries

Independent Trustee Services

Mr Andrew Kerr

Mercer

Mr Denzil Morgan

National Federation of Occupational Pensioners

The Pension Protection Fund

The Pensions Advisory Service

Royal London

Railways Pension Trustee Company Limited and RPMI Limited

Sackers & Partners

The Society of Pension Professionals

Spence & Partners

Squire Patton Boggs

Mr Paul Waterhouse

Willis Towers Watson

Annex B: List of Responses from Organisations to our November Consultation

Association of Consulting Actuaries

Association of Pension Lawyers

Mercer

Mr Denzil Morgan

The Pensions Advisory Service

The Pension Protection Fund

Royal London

The Society of Pension Professionals

Squire Patton Boggs

Mr Graham Welland