

SECURITY OF PENSION BENEFITS

DIFFERENCES BETWEEN PUBLIC SERVICE AND PRIVATE SECTOR SCHEMES

Staff transferred from the public service to the private sector as part of a PFI or PPP exercise will usually be subject to a change in their pension arrangements. The government's Fair Deal policy describes the pension protections which normally apply to transferring employees. Before transfer they will have been eligible to accrue pension benefits in a public service scheme. Afterwards they will usually be entitled to continue to accrue benefits, which are broadly comparable to those in the public service scheme, in their new employer's private sector scheme. Those who join the new employer's scheme will have the option of transferring their benefits, accrued within the public service scheme, into the private sector scheme.

There are a number of issues which individuals will need to consider before reaching a decision on whether or not to transfer the pension they have built up. Two of the factors which they should take into account are any change in the method used to provide pension benefits and the level of security of their benefits following a transfer.

The Government Actuary's Department (GAD) has prepared this note which examines how pension benefits are provided and secured in the public service and the private sector.

GAD is a government body which, amongst other functions, advises on various pensions aspects of PFI and PPP initiatives. GAD has no financial interest in whether or not employees transfer their accrued public service benefits into private sector schemes and therefore GAD's advice is entirely impartial. GAD does not give individual advice and should such advice be required it should be obtained from an Independent Financial Adviser.

SECURITY OF BENEFITS IN PUBLIC SERVICE SCHEMES

Constitution

Public service pension schemes are normally established under an Act of Parliament and are underwritten by the government. The benefits and contributions for each public service scheme are normally set out in regulations or rules approved by Parliament.

This means that the benefits are guaranteed to be paid in full. However, Parliament has the option of making changes to legislation, including the terms on which past and future pensions are payable. This general power is limited by wider obligation, for example by the Human Rights Act.

With the exception of the PCSPS Partnership Scheme, these schemes provide benefits which are defined by reference to the length of scheme membership and salary. Pension schemes in both public and private sectors which provide benefits in this form are known as 'defined benefit schemes'.

Funding

Most public service schemes are unfunded and operate on what is known as a 'pay-as-you-go' (or 'unfunded') basis. This means that the contributions paid by members and employers in any particular period are not invested. They are used, along with money from government, to pay benefits to current pensioners. The Civil Service, NHS, Teachers, Police and Fire schemes all operate on this unfunded basis.

The Local Government scheme is the only main public service scheme which invests the contributions paid in a particular period to meet the payments of benefits to the members paying the contributions, or having contributions paid on their behalf, in future. The benefits are defined in legislation and are backed by the financial strength of local government.

The underlying guarantee applies regardless of the extent to which benefits are funded thus the level of security is unaffected by the existence or otherwise of scheme assets and is very high.

SECURITY OF BENEFITS IN PRIVATE SECTOR SCHEMES

Constitution

Private sector pension schemes are usually in the form of a trust. This is a structure legally separate from the employer of the scheme members. Each scheme has trustees who are responsible for collecting and investing contributions and the day-to-day running of the scheme in accordance with the terms of the trust. The scheme's 'Trust Deed and Rules' will include details of the benefits to which scheme members are entitled. Contributions are paid by members and their employer and these are invested in assets to secure the benefits payable under the scheme. The assets of the scheme are invested separately from those of the employer so if the employer becomes insolvent the scheme's assets are still available to meet benefits payable by the scheme.

Private sector schemes are subject to both trust law and pensions law which has developed over many years. Many of the laws governing the way in which schemes operate are intended to provide security to members, although it must be recognised that the level of security offered by these rules is lower than that implied by a government guarantee.

An Act of Parliament, the Pensions Act 2004, was recently introduced with the aim of further improving security of pension benefits. Some of the Act's provisions are being phased in over a period. The following sections explain the position as they affect defined benefit schemes once all the Pensions Act provisions are in place.

Funding

With the introduction of the Pensions Act 2004 private sector schemes became subject to a 'Scheme Funding Obligation' (SFO). This means a defined amount of assets must be held to cover the value of the scheme's liabilities. If the scheme's assets are less than the required amount then the employer must agree to pay contributions at a rate which will bring them up to the minimum level over a limited period. This provision is being phased in over a three year period and some schemes are still subject to the previous regime.

Before the SFO was introduced private sector schemes were subject to a 'Minimum Funding Requirement' (MFR). This also required a defined amount of assets be held to cover the value of the scheme's liabilities. If the assets were less than required the employer had to agree to additional contributions over a limited period.

The SFO (and previously the MFR) provides a framework for trustees, in agreement with the sponsoring employer, to make funding arrangements to meet the scheme's pension commitments over the long term in which they fall due, assuming the scheme will continue in existence and be the payer of the ultimate benefit. The continued payment of employer contributions is dependent on the strength of the employer.

Neither the SFO (nor MFR) require sufficient assets to be held at any particular time to secure benefits with an insurance company should the scheme be discontinued, for example in the event of employer insolvency. The price insurance companies charge for securing benefits tends to be relatively high due to the constraints they operate under which are intended to minimise the chances that the benefits will not be paid.

Even though the scheme is separate from the company, in most cases it is impractical for the scheme to continue indefinitely without a sponsoring employer and the only option is to use whatever funds are available to buy benefits for the members from an insurance company.

Benefit 'guarantees'

Before the Pensions Act 2004 there were only limited provisions to protect members of schemes which discontinued in circumstances where there was insufficient money to buy out benefits with insurance companies. The Act introduced an organisation called the Pensions Protection Fund (PPF) which offers more substantial protection for scheme members. In outline, in the event of employer insolvency, the PPF protects in full pensions being paid to those over normal retirement age and protects 90% of benefits for other members, in the latter case subject to a cap, currently of £26,050 p.a. Future increases in pensions may not be fully protected. The PPF is funded by a levy paid by all schemes eligible for its protection and has no underlying government guarantee.

There are other aspects of general pensions law which protect members' benefits in private sector schemes. For employees transferring from the public to private sector, additional commitments are required under the Fair Deal policy from private sector schemes and their sponsors.

General Pensions law

Amendment of scheme rules

The Pensions Act 1995 introduced a requirement that no pension scheme could reduce the value of a member's pension entitlement to date without that member's consent. The detail of this protection was changed slightly by the 2004 Pension Act but the fundamental principle remains that benefits already built up cannot be reduced.

Debt on employers

The Pensions Act 1995 also introduced an obligation on employers to pay additional money into the scheme in the event the scheme was discontinued. The way in which the amount due is calculated has changed over the years since this was originally introduced. Employers must now pay sufficient to fully secure benefits with insurance companies. This applies equally to solvent and insolvent employers. Although in cases of insolvency there are unlikely to be sufficient funds available to meet this obligation. If, after any amounts recoverable have been collected, there are insufficient funds to fully secure benefits the PPF remains as a fall back.

Transfers from public to private sector – Fair Deal protection

Under Fair Deal when employees are transferred to private sector schemes those schemes have to comply with additional provisions, over and above those imposed by general pensions law. These are intended to give transferring members additional security for their pension benefits. The main additional protections are:

Member trustees

The private sector scheme has to provide, except for in very limited circumstances, for member representation on the trustee body. Previously employers were, subject to member agreement, able to opt out of member nominated trustees arrangements. Any such opt outs will cease to have effect no later than 31 October 2007.

Additional security for benefits

The private sector scheme must provide for greater than statutory protection of ex-public service employee benefits in the event of scheme wind up, onward compulsory transfer of employment and scheme amendment. In each case the statutory requirement is to protect members' entitlements based on leaving service benefits. This would consider a member's pensionable service and salary at date of leaving and, normally, allow only for increases in the period between leaving and retirement in line with the Retail Price Index subject to an overall limit of 5% a year. Under the additional provisions for members transferring from the public service the protection must consider a member's pensionable service and salary at date of leaving but then allow for expected salary increases in the period between leaving and retirement. In general, salaries rise more quickly than prices, and are also increased with performance and promotion.

Individual transfer values

For ex-public service employees leaving the private sector scheme voluntarily the scheme must offer a transfer value which represents the full value of the member's accrued rights. The statutory provision would otherwise allow schemes to reduce transfer values if the scheme was underfunded at the time.

**Government Actuary's Department
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