Department
for Work &
Pensions

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

Public consultation

August 2017

Contents

Introduction

This consultation concerns proposed changes to regulations using powers under paragraph 33 of Schedule 7 to the Pensions Act 2004, as amended by paragraph 15 of Schedule 8 to the Pensions Act 2008. The draft regulations enable Pension Protection Fund (PPF) compensation to reflect the different rates payable to members in receipt of, or who would have been entitled to receive, a bridging pension under their scheme rules.

The regulations are designed to fix an anomaly whereby pensioner members in receipt of a bridging pension at the higher rate when their scheme enters the PPF, receive PPF compensation based on this rate for life. Had the pension scheme not entered the PPF, the member's scheme pension payments would have reduced at State Pension Age (SPA) or at another point stipulated in their pension scheme rules. 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 in that the amount of compensation they receive may exceed the amount they would have received had their scheme not entered the PPF. Currently, these members also take a disproportionate amount of scheme assets when their scheme enters a PPF assessment compared with other members of the scheme who are not in receipt of a bridging pension. The proposed changes will enable the PPF to reduce compensation payments so that the compensation received by these members, in this respect, more closely reflects the benefits that they would have received in their pension scheme. It will also ensure greater parity of treatment between members in the PPF and the Financial Assistance Scheme (FAS) which already takes account of bridging pensions.

About this consultation

Who this consultation is aimed at

We expect this consultation to be of interest to pension scheme trustees and administrators, members of defined benefit (DB) occupational pension schemes, PPF levy payers and the PPF Board itself. However, the Government also welcomes views from individuals receiving compensation from the PPF and any other interested parties.

Purpose of the consultation

The aim of the consultation is to gather views on the benefits and any possible unintended consequences of the Government's preferred option to reflect bridging pensions by smoothing the amount of PPF compensation over a member's lifetime. To help respondents to fully consider the possible benefits and consequences of smoothing, the Government has also outlined an alternative approach of moving members to a lower rate of compensation ("step down") after they reach SPA or the appropriate date as defined in their scheme rules. The Government believes that this latter approach introduces substantial complexity into the current system but welcomes views on the implications.

Discussions with stakeholders in 2011/12 in connection with changes in the state pension age indicated that a significant minority of pension schemes offered some form of a bridging pension, and that in some cases a bridging pension was the default option, or an automatic right. The Government is grateful to all those who responded at that time but recognises that the pension landscape has changed considerably in the intervening years and therefore wishes to gather further evidence on the scale and nature of pension schemes which offer bridging pensions.

The Government would also welcome any evidence from pension scheme administrators on whether the proposed approach to smooth a member's compensation payments would create significant operational difficulties and from scheme members, who are receiving a bridging pension or will receive one as an automatic right, on the practical implications of receiving a fixed rate of PPF compensation, subject to indexation, for life.

The consultation also seeks views on whether the draft Pension Protection Fund (Compensation) (Amendment) Regulations 2017 achieve their intended purpose.

Scope of consultation

This consultation applies to England, Wales and Scotland. It is anticipated that Northern Ireland will make corresponding regulations.

Duration of the consultation

This consultation closes on Sunday 1 October 2017.

How to respond to this consultation

Please send your consultation responses to:

Nick O'Neill

PPF and NEST Partnership

Private Pensions Policy and Analysis

First Floor, Caxton House

Tothill Street

London, SW1H 9NA

Email: bridging.pensionsconsultation@dwp.gsi.gov.uk

Government response

We will aim to publish the government response to the consultation on the GOV.UK website. The consultation principles encourage Departments to publish a response within 12 weeks or provide an explanation why this isn't possible. Where consultation is linked to a statutory instrument responses should be published before or at the same time as the instrument is laid.

The report will summarise the responses and any action we will take, or have taken, in respect of them.

How we consult

Consultation principles

This consultation is being conducted in line with the revised Cabinet Office consultation principles published in January 2016. These principles give clear guidance to government departments on conducting consultations.

Feedback on the consultation process

We value your feedback on how well we consult. If you have any comments about the consultation process (as opposed to comments about the issues which are the subject of the consultation), including if you feel that the consultation does not adhere to the values expressed in the consultation principles or that the process could be improved, please address them to:

DWP Consultation Coordinator
2nd Floor
Caxton House
Tothill Street
London
SW1H 9NA

Email: caxtonhouse.legislation@dwp.gsi.gov.uk

Freedom of information

The information you send us may need to be passed to colleagues within the Department for Work and Pensions, published in a summary of responses received and referred to in the published consultation report.

All information contained in your response, including personal information, may be subject to publication or disclosure if requested under the Freedom of Information Act 2000. By providing personal information for the purposes of the public consultation exercise, it is understood that you consent to its disclosure and publication. If this is not the case, you should limit any personal information provided, or remove it completely. If you want the information in your response to the consultation to be kept confidential, you should explain why as part of your response, although we cannot guarantee to do this.

To find out more about the general principles of Freedom of Information and how it is applied within DWP, please contact the Central Freedom of Information Team:
Email: freedom-of-information-request@dwp.gsi.gov.uk

The Central FoI team cannot advise on specific consultation exercises, only on Freedom of Information issues. Read more information about the Freedom of Information Act.

The Pension Protection Fund

The Pension Protection Fund (PPF) was established by the Pensions Act 2004. It provides compensation to members of defined benefit 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. Schemes that wound up or started to wind up prior to 6 April 2005 fall under the Financial Assistance Scheme (FAS).

The PPF is funded via a combination of the transferred scheme funds, recoveries from insolvent employers, investment return and a levy on eligible schemes. The FAS is funded mainly via general taxation.

Following an employer insolvency event, the scheme moves into a PPF assessment period during which the scheme assets are tested against the cost of buying annuities at PPF compensation levels. The scheme continues to be run by its trustees during the assessment period but benefits are limited to PPF compensation rates. If a scheme has sufficient assets to purchase annuities of at least PPF compensation levels, it leaves the PPF assessment period and winds up as normal. If the scheme does not, the assets and members are transferred to the PPF and members are paid compensation.

PPF compensation is paid to those over the scheme's normal pension age, or who are in receipt of ill-health or survivors' pension, at the date of the insolvency event at 100 per cent of the pension in payment, or due, at that date. Anyone else is paid compensation that reflects 90 per cent of the accrued pension, subject to an overall cap. From 1 April 2017, the cap at age 65 is £38,505.61 (this equates to £34,655.05 when the 90 per cent level is applied). The long service cap was introduced on 6 April 2017 and applies to members who have 21 or more years' service in their scheme. For these members the cap is increased by 3 per cent for each full year of pensionable service above 20 years, up to a maximum of double the standard cap.

Bridging pensions

Some defined benefit occupational pension schemes offer bridging pensions. Broadly speaking, these allow members of such schemes who retire before reaching SPA to be paid a higher rate of pension until they reach SPA or the appropriate date as defined in the pension scheme rules. The bridging 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 that a scheme member's bridging pension reduces can vary from scheme to scheme and may not always be the date that the member began to receive their state pension. Therefore, for the purpose of the consultation, we refer to the date that scheme members' bridging pension reduces as the 'appropriate date'.

Example:

Member A retires after 40 years employment at age 60. A scheme might provide a lifetime pension of £13,500 per year plus a bridging pension of £3,000 per year until the member reaches the appropriate date giving a total pension of £16,500 per year. At the appropriate date member A's bridging pension ceases and the pension is reduced to £13,500 per year.

Pension Protection Fund compensation and bridging pensions

Under current regulations, PPF compensation payments do not take account of any scheduled changes to the member's pension entitlement after the date that the pension scheme enters PPF assessment. Therefore, members in receipt of the high rate of a bridging pension on the day before their scheme's PPF assessment period currently receive PPF compensation based on this higher rate for life. Similarly, in the rare cases where deferred members have an automatic right to a bridging pension, their PPF compensation would be based on the initial, high rate and, subject to indexation, paid at that amount for their lifetime.

Proposed changes in the treatment of bridging pensions by the Pension Protection Fund

The draft Pension Protection Fund (Compensation) (Amendment) Regulations 2017 are designed to correct the anomaly whereby certain members in receipt of, or with an automatic right to, a bridging pension continue to receive compensation based on the high rate for life. 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 in that the amount of compensation they receive may exceed that they would have received had their scheme not entered the PPF. The proposed changes mean that, in future, the amount of compensation received by these members will, in this respect, more closely reflect the benefits that they would have received had their scheme not entered the PPF.

The proposed changes will also ensure greater parity of treatment between members in the PPF and the FAS which already takes account of bridging pension payment levels.

Who will be affected?

The changes potentially affect:

- pensioner members

- deferred members
- the spouses and other dependents of pensioner, and deferred members.

The proposed changes will only apply to members of pension schemes which enter a PPF assessment period on or after the date that final regulations come into force. Members with a bridging pension who are already in receipt of PPF compensation, or where their scheme is already in a PPF assessment period, will not be affected.

Once this change comes into effect, will mainly affect pensioner members, that is those who have already retired and taken their scheme benefits but are still below the appropriate age when their scheme enters the PPF.

For deferred members, PPF compensation is currently based on the default option where they have options at their scheme's normal pension age. This will not change under the draft regulations.

Deferred members will be affected by these changes where the standard pension to which they are entitled on retirement under the rules of their scheme is a bridging pension. We understand, however, that this is rare and that the more usual scenario is that members have an option to receive a bridging pension when they reach their normal retirement date (or actually retire, if earlier), in which case compensation would in any event be based on the standard, non-bridging pension option.

Where a bridging pension is the default retirement benefit payable under the scheme rules, rather than an option, the proposed regulations mean that PPF compensation payable to deferred members will reflect the reduction that would have taken place under the original scheme rules.

The Government would be interested to receive any evidence on how many schemes have a bridging pension as the default retirement benefit payable under the scheme rules when a member reaches their normal retirement date set out in the schemes rules (or retire, if earlier).

Generally, widows, widowers and civil partners receive compensation based on half of the PPF's member's entitlement. Dependent children may also receive compensation. Scheme rules vary in respect of how bridging pensions are reflected in benefits paid to surviving dependents and the Government would be interested to see some examples.

Implementation

The Government considered two options to implement these changes.

Option 1: Smoothing (proposed approach)

The Government's proposed approach is to calculate PPF compensation by actuarially converting bridging pensions into a flat-rate[1] lifetime-equivalent amount. In this case, affected members would expect to receive broadly the same total amount over their lifetime as they would have done if the compensation had reflected the step down structure – though, like any actuarial calculation, the final outcome will vary according to member's actual lifespan, among other factors.

The advantages of this approach is that it gives members certainty on how much PPF compensation they will receive for life as well as being the most straightforward for the PPF to implement and administer. With regard to the latter point, this approach ensures that the PPF compensation calculation, which can often be complex, is carried out only once and can be undertaken using existing IT systems. Any solution which requires a second calculation at the appropriate date will add complexity and is likely to be carried out manually, at least initially, as PPF IT systems are not currently programmed to calculate changes in compensation rates.

Smoothing in practice

During the PPF assessment period, the trustees of the scheme retain responsibility for managing the scheme but benefits are limited to PPF compensation rates. For this purpose and in order to carry out the scheme valuation, the trustees calculate the compensation members would receive should the scheme enter the PPF, taking into account PPF rules on compensation levels and the cap.

Under the smoothing approach, as part of this calculation trustees would be required, using actuarial factors provided by the PPF, to smooth bridging pensions over the affected members' assumed lifetime.

We have assumed that, as smoothing is intended to be actuarially neutral, it will not affect the valuation calculation.

In the event of the death of the member, surviving dependents would receive compensation in accordance with the current PPF rules, with the calculation based on the smoothed compensation the late member was receiving.

<u>Examples:</u>

Member A in the previous example was born on 1 October 1959. His scheme enters a PPF assessment period on 3 January 2020. His higher rate of bridging pension is due to step down at age 65. Using illustrative actuarial factors provided by the PPF for the purposes of this consultation, the trustees convert the higher rate of bridging pension which means that the Member A's payments would reduce during the PPF

[1] Subject to PPF indexation

assessment phase from £16,500 per year to £14,100 per year and, if the scheme enters the PPF, will continue at this level over the rest of his lifetime, subject to indexation.

Member B retired early at age 60. His scheme's Normal Pension Age is 63 and his bridging pension is due to cease at age 65. His scheme enters a PPF assessment period when Member B is aged 61. Under PPF rules, Member B receives 90% of his lifetime pension at the PPF assessment date £29,000 per year and 90% of his bridging pension £2,000 per year which is converted to a lifetime pension of £340 per year using illustrative PPF factors. This gives a total lifetime pension of £29,340 per year. If 90% of the compensation cap at age 61 is £30,000 per year [2]then Member B's compensation falls just under the cap and no further adjustment is made and is payable at the rate of £29,340 per year plus pension increases.

The Government recognises that, through smoothing, pensioner members entering the PPF assessment period when in receipt of the high rate of their pension will see an initial reduction in their payments, over and above any other reductions in line with PPF compensation rules. However, the actuarial adjustments aim to ensure that, overall, members should be no worse off than if their compensation had reflected their pension scheme's step down structure. Like any actuarial calculation, however, the final outcome will vary according to the individual's own lifespan.

Under this approach, members will not experience a further reduction to their compensation when they reach the date when their pension payments would have stepped down in line with their scheme rules.

The Government would be interested to understand whether members with bridging pensions would value having fixed regular monthly payments, should their scheme enter the PPF.

Option 2: Mirror existing scheme rules

Under this approach, the PPF would pay a member compensation based on the higher rate until the date specified in the rules of the original scheme (typically SPA). At this point, the member's PPF compensation would be recalculated to reflect the lower rate of the on-going pension.

Mirroring existing scheme rules in practice

The PPF is a compensation scheme and does not generally mirror individual scheme rules. Using this approach would represent a step change in the way that the PPF operates and is likely to be significantly more complex for it to administer.

There is no standard model for how bridging pensions operate in practice so reducing the member's compensation at the appropriate date would require separate calculations for each individual scheme. It would make PPF compensation

[2] A PPF compensation cap of £30,000 has been used for illustrative purposes in this example.

calculations more difficult, particularly in complex areas such as the application of the compensation cap, which will have to be revisited when the step down reduction takes place.

The Government would be keen to see examples of how bridging pensions are written into scheme rules.

Under option 2, members entering the PPF assessment period will not see an initial reduction in the payments they are receiving in respect of their bridging pension as they would with smoothing. However, once the step down is applied, their PPF compensation will be lower for the rest of their lifetime than it would have been had their bridging pension been smoothed on entry into the PPF assessment period.

<u>Example:</u>

Member B used in the previous example would receive £30,000 per year [3]after the PPF cap is applied because the lifetime pension plus bridging pension comes to £31,000 per year. Because Member B's lifetime pension ignoring the bridging pension at age 61 was lower than the cap then the pension at age 65 steps down to the level that the lifetime pension (£29,000 per year) would have reached by age 65 after taking into account pension increases. If we assume pension increases of 2% per year between age 61 and 65 then the pension at 65 steps down to £31,390 per year.

The Government is particularly keen to hear the views from scheme members on this issue.

In the event of the death of the member, surviving dependents would receive compensation in accordance with the current PPF rules. If option 2 were adopted, the Government would need to consider whether compensation for any surviving dependents should reduce at the point that the deceased member's compensation would have stepped down under their original scheme rules.

Preferred implementation approach

On balance, due to the additional complexity inherent in option 2, the Government believes that smoothing PPF compensation over the member's lifetime would be the most effective way to take account of bridging pensions.

[3] A PPF compensation cap of £30,000 has been used for illustrative purposes in this example.

Other matters

Step-ups and Guaranteed Minimum Pensions

The majority of salary-related pension schemes were “contracted-out” of the additional State Pension.

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.

For example, under the scheme’s rules a man could become entitled to his scheme pension at age 60. But at age 65, if the pension did not meet the GMP requirements, an uplift would be necessary to ensure that the GMP requirements are met.

Given the complexity involved with applying GMPs and that we do not know how many individuals may be affected, it is the Government’s view that we should allow industry and the PPF to familiarise themselves with the changes made in respect of step downs, before embarking on any further changes.

The Government would therefore be interested in any evidence of the numbers affected by this issue and views on whether, in future, PPF compensation should take account of increases in the member’s scheme pension which would have taken place at GMP age (60/65) to ensure that the GMP requirements are met.

Equality impact

The Government would welcome any evidence or information that respondents can provide about whether the proposed changes to PPF compensation in respect of bridging pensions, and adopting option 1 as described above, could have particular impacts in relation to individuals who share certain protected characteristics.

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

Consultation Questions

Question 1: Do you have any evidence on how many schemes offer bridging pensions 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 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?

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

Question 10: Do 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.