Thought piece

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Workplace pension developments: an introductory guide

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There are two main types of workplace pension scheme in the UK:

1. Defined benefit (or final salary) schemes, under which benefits are paid to members based on the rules of the arrangement rather than directly related to the contributions paid. The specified benefit at retirement is typically based on a formula linked to levels of pay and service.

2. Defined contribution (or money purchase) schemes, under which contributions paid are invested to build up pots of money for members to use to provide an income in retirement. There are two main types of defined contribution scheme:

   a. Trust-based schemes, under which the scheme is run by trustees; and

   b. Contract-based schemes, under which the scheme is run by a third-party (normally an insurance company) and there is a contract between each member and the scheme provider.

There are also other types of arrangement such as hybrid schemes, which consist of both defined benefit and defined contribution elements.

A brief summary of the main current developments relating to workplace pension schemes are as follows:

Budget 2014 changes

The 2014 Budget introduced major changes to allow individuals with defined contribution funds greater choice on how to take their benefits. Most of these changes are expected to apply from April 2015 and are subject to the development and finalisation of legislation. The main changes are:

- The effective abolition of the requirement to buy an annuity in a defined contribution scheme from April 2015;
- Allowing those with a defined contribution pension to draw down from it after minimum pension age, subject to their marginal rate of income tax;
- Increasing the earliest age that members can typically access their pension benefits from age 55 to age 57 in the 2020s;
- The requirement for free face-to-face guidance to be made available at the point of retirement;

In addition, some interim changes came into effect from 27 March 2014. The main ones were an increase in the small lump sum payment limit from £2,000 to £10,000 and an increase in the trivial commutation limit from £18,000 to £30,000. This change applies to defined benefit as well as defined contribution schemes and enables members with a small amount of benefit to take these benefits as a

lump sum.

Automatic enrolment

Changes to legislation were made in 2008 which require every employer to automatically enrol employees into a workplace pension scheme if they meet certain criteria. The changes came into force on 1 October 2012 for the very largest employers and are being phased in for other employers over a period to 2017, with each employer being a staging date based on its size and circumstances.

The criteria for employees who need to be enrolled are broadly those aged between 22 and State Pension age who earn more than £10,000 a year and work in the UK. The workplace pension scheme that employees are enrolled into must also meet minimum standards.

The end of contracting-out

To reflect the increase in National Insurance contributions associated with the end of contracting-out, employers will have powers to amend future service benefits and/or member contribution rates within private sector occupational pension schemes. This power will be available to employers for a five-year period from 6 April 2016 to 5 April 2021. In certain industries, such as the railways industry, the power cannot be used for members with protected person status.

As part of the end of contracted-out employment, HMRC will offer a service which enables Guaranteed Minimum Pension (GMP) data held on scheme records to be compared against HMRC records. It is expected that this service will be withdrawn in due course, potentially in 2018. GMPs apply to those who were contracted-out of the State Earnings Related Pension Scheme, the predecessor to the State Second Pension, between 6 April 1978 and 5 April 1997.

Changes to the Annual Allowance, the Lifetime Allowance and Individual Protection

One of the key advantages of saving in a pension scheme is that contributions paid are provided with tax relief. However, from a member's perspective, limits apply on the level of contributions and benefits payable before tax charges are payable. Since 6 April 2006, the limits have been:

- The Annual Allowance, which is the level of annual pension saving that can be provided with tax relief in a period of 12 months and is currently £40,000, having been reduced from £50,000 to £40,000 with effect from the 2014/15 tax year.

- The Lifetime Allowance, which is the total amount of pension savings that an individual can build up within registered pension schemes during his or her lifetime before further tax charges are payable. The current Lifetime Allowance is £1.25 million, having reduced from £1.5 million to £1.25 million with effect from 6 April 2014.

Various types of protection have applied as part of both the introduction and changes to the Lifetime Allowance. One of these, Individual Protection 2014 (IP2014) was introduced as part of the reduction in the Lifetime Allowance to £1.25m and can give a protected lifetime allowance equal to the value of an individual's pension rights on 5 April 2014, up to an overall maximum of £1.5 million. IP2014 applications can be made up to 5 April 2017.

Changes to the Pensions Regulator's Codes of Practice

The Pensions Regulator has been the regulator of UK work-based pension schemes since it was introduced by the Pensions Act 2004. It has various statutory objectives set in legislation which include promoting and improving understanding of the good administration of work-based pensions and protecting member benefits.

The Pensions Regulator has issued various codes of practice to give practical guidelines on how to comply with the legal requirements of pension regulation as well as regulatory guidance. Recent developments relating to the codes of practice have been:

- An updated code of practice on pension scheme funding ("Code of practice 03") to reflect changes in the Pension Regulator's statutory objective to take account of the sustainable growth plans of the sponsoring employer in scheme funding decisions; and

- A new code of practice ("Code of practice 13") to cover governance and administration requirements for occupational defined contribution trust-based schemes.

Survivor benefits for same sex couples

The introduction of the Marriages (Same Sex Couples) Act 2013, which allows same-sex couples to marry, means that pension schemes are now required to provide the survivor of a same sex marriage with the same benefits as would be payable to an opposite sex spouse but only for service from 5 December 2005 (rather than full pensionable service). Consequently, schemes may need to update rules and processes to allow for this.

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Previously, the Civil Partnership Act 2004 gave same sex couples the right to register as civil partners with effect from 21 December 2005 and had required pension schemes to provide the survivor of a civil partnership with the same benefits as would be payable to an opposite sex spouse but, again, only for service from 5 December 2005. The significance of 5 December 2005 is that it was the date that the Civil Partnership Act 2004 came into force.

Pension liberation

Pension liberation or pension scams typically involve a company claiming it is able to release cash from a pension scheme as a loan or lump sum earlier than the law permits (currently age 55) if individuals transfer the pension pot to a designated pension scheme. The pension company often work with 'introducers' or 'advisers' who try to entice the public, especially financially vulnerable individuals with spam text messages, cold calls or website promotions into transferring their pension pots. Unfortunately, those who proceed with transfers to such arrangements often lose most, if not all, of their savings, and receive tax charges of over half the value of their pension rights as payments made before age 55 are typically classified as an 'unauthorised payment'.

The Pensions Regulator in conjunction with the Pensions Advisory Service and Action Fraud have produced guides for members to alert them of the dangers of the various types of pension scams and raise awareness of the issue. Members requesting transfer value quotations are routinely supplied with this information.

Cessation of refunds from defined contribution schemes

The Pensions Act 2014 introduced a reduction in the period under which a refund of member contributions can be provided, from 2 years to 30 days of qualifying service, in respect of for trust-based defined contribution schemes. However, the implementation date for this is yet to be announced.

Under contract-based defined contribution schemes, the requirements are already that member contributions are not refunded.

Transfer of small pension pots

The Pensions Act 2014 sets out a legislative framework so that regulations can be introduced for consolidation of small money purchase pension pots. If this approach goes ahead, this will involve the automatic transfer of defined contribution pots less than £10,000 when the associated member becomes an active member of a new defined contribution scheme. The approach is only expected to apply to pension pots which started to accumulate after a date to be specified in regulations.

If the approach goes ahead there will be specified procedures for defined contribution schemes to follow.

Change to definition of money purchase benefits

The Pensions Act 2011 made revisions to the definition of money purchase benefits and regulations/orders have been introduced during 2014 to bring the changes into effect. Consequently, benefits that have previously been classified as defined contribution ones may now be classified as defined benefit.

Defined contribution charge cap

The Pensions Act 2014 includes powers to allow the government to restrict the administration charges that can be applied to a defined contribution scheme member and, from April 2015, a 0.75% cap on charges will be introduced for the default funds of all auto-enrolment qualifying schemes. In addition, the government has the ability to extend the cap beyond those used for auto enrolment.

There are also some changes to governance requirements to coincide with the introduction of a cap on charges.

Changes to Pension Protection Fund compensation for those with long service

The Pension Protection Fund is set up to provide compensation to members of eligible defined benefit pension schemes in the event that the employer suffers a qualifying insolvency event (such as entering into administration) and there are insufficient assets in the pension scheme to cover the Pension Protection Fund level of compensation. It is funded by levies which are charged on all schemes which may be eligible to enter the Pension Protection Fund.

There has been a cap on the amount of compensation available in the Pension Protection Fund and the Pensions Act 2014 increases this compensation cap for those who have more than 20 years' service with an employer. It is expected that this change will be introduced from 6 April 2015.

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Changes to Pension Protection Fund levy calculations

The Pension Protection Fund is making changes to its levy calculations from 2015/16 as part of its change of insolvency risk score provider from D&B to Experian. Although there are no changes to the amount of total levy that the Pension Protection Fund will expect to raise as a consequence of this, there will be some schemes that are required to pay higher levies as a result of the changes whilst others that will pay lower levies.

Defined Ambition and Collective Defined Contribution schemes

The Pensions Schemes Bill 2014, when finalised and enacted, will introduce shared risk schemes and collective schemes into UK legislation. As a consequence of this, there is the possibility that any employers wishing to make benefit changes may wish to utilise the new possibilities. Of these, the use of collective defined contribution schemes may be both the most frequent choice and the one which requires greatest change to our systems/processes. Collective defined contribution schemes pool risk between members and typically will target a stated level of retirement benefits. They would have different valuation and reporting requirements compared to defined benefit or defined contribution schemes.

Guaranteed Minimum Pension equalisation

In 2012, the Department for Work and Pensions published a consultation relating to the equalisation of benefits to reflect Guaranteed Minimum Pensions. The calculation of Guaranteed Minimum Pensions is inherently different between men and women but, since 17 May 1990, and differences in benefits paid from pension schemes for men and women are unlawful. As a consequence of the differing calculations of Guaranteed Minimum Pensions between males and females and the different increases that can apply to them, small differences in the benefits paid to men and women can arise. For many years, there had been significant doubt about whether equalisation of benefits to reflect these differences was required but the Department for Work and Pensions has indicated that GMP equalisation is required, although there remains doubt about how it would be done.

At some stage, we can expect a response to the 2012 consultation. The consequence of this may be that a Guaranteed Minimum Pension equalisation exercise needs to be undertaken by schemes.

Revisions to the IORP Directive

A draft of a revised Directive for “institutions for occupational retirement provision” (the IORP Directive) was published by the European Commission on 27 March 2014. The IORP Directive governs the activities of occupational pension schemes within the European Union.

The proposals, which are still subject to changes as they start to get considered at European Parliament level, are expected to introduce new governance, risk-management, and member-communication obligations. However, the details relating to these are unknown, especially as: it is likely that changes to the IORP Directive may be made as it progresses through European Parliament; and how the Directive is then interpreted in the context of UK legislation.

It is expected that the provisions of the new IORP Directive will need to be implemented by EU Member States by 31 December 2016.