Collective Benefit Schemes in the UK: Where have we got to?

Paper prepared for the International Pension and Employee Benefits Lawyers Association Conference Workshop on Defined Ambition/Shared Risk/Collective DC Plans & Other Innovative Designs (18th May, 2015).

PHILIP BENNETT
PARTNER

SLAUGHTER AND MAY
ONE BUNHILL ROW
LONDON
EC1Y 8YY

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COLLECTIVE BENEFIT SCHEMES[1] IN THE UK WHERE HAVE WE GOT TO?

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A. UK BACKGROUND LEADING TO THE LEGISLATION TO ESTABLISH COLLECTIVE BENEFIT SCHEMES

1. Accounting and economic background

1.1 A combination of low long-term interest rates, improvements in longevity and the accounting treatment under FRS 17[2] and IAS 19[3] (along with legislative risk transfers (see **2**. below)) have all added to the pressure on UK employers offering defined benefit pension schemes to stop providing benefits under those schemes[4].

1.2 By way of illustration of this, as at June, 2014 only 4 of the companies in the FTSE 100 are on record as offering to employees defined benefit pension schemes which are open to new employees.

1.3 Furthermore, the effect of the accounting standards is that the deficit in the defined benefit pension scheme will, in general, appear on the balance sheet of the sponsoring employer (albeit measured on the basis required by the accounting standard which will usually be different from the basis used by the pension scheme trustees for determining the liabilities (or technical provisions) of the defined benefit pension scheme).

2. Legislative risk transfer

2.1 Robert Maxwell, who died on 5th November, 1991, can, almost single-handedly, be viewed as the person who galvanised the UK Government into introducing the first UK Act of Parliament (the Pensions Act 1995) which set out a detailed legislative and regulatory framework for occupational pension schemes in the UK (and, in particular, for defined benefit occupational pension schemes in the UK).

[1] This is a terminology used in the Pension Schemes Act 2015. For a further explanation of the terminology used in the UK in this area please see further **Section C.** below.

[2] Financial Reporting Standard 17 'Retirement Benefits' is issued by the Accounting Standards Board. This is in the process of being replaced by the broadly equivalent requirements contained in FRS 102 (the Financial Reporting Standard applicable in the UK and Republic of Ireland), which will apply for accounting periods starting on or after
1st January, 2015.

[3] International Accounting Standard 19 is an accounting rule concerning employee benefits under the IFRS rules set by the International Accounting Standards Board.

[4] For non-UK readers, the term "pension scheme" (or "occupational pension scheme") is the term generally used in UK legislation; see, for example, the Pension Schemes Act 1993 and the Pension Schemes Act 2015.

2.2 In relation to a defined benefit occupational pension scheme in the UK, current UK legislation[5]:

(a) imposes a mandatory qualitative (not quantative) funding standard.

(b) makes the employer liable to fully fund the defined benefit pension scheme on a buy-out[6] basis if:

(i) the pension scheme starts to wind-up,

(ii) the employer becomes insolvent, or

(iii) the employer goes into a solvent members' voluntary winding-up[7].

Note: Where the scheme is an occupational pension scheme with 2 or more employers which provides defined benefits, then if one of the employers ceases to employ active members at a time when one or more other employers continues to employ active members, then the outgoing employer will, *prima facie*, become liable to pay immediately its share of the scheme's deficit calculated on a buy-out basis.

(c) confers on the UK Pensions Regulator power to require other companies (or individuals in some cases) to contribute to the deficit in a defined benefit occupational pension scheme (in addition to the employer in relation to the scheme). The Pensions Regulator's powers include the power to issue:

(i) a contribution notice against any company or individual (who is sufficiently connected or associated with the employer) to make a payment to the scheme (up to the scheme's deficit measured on the buy-out basis) and

(ii) a financial support direction against any company (but excluding an individual in his or her capacity as an employee or director) who is sufficiently connected or associated with the employer to provide financial support to the scheme.

Note 1: These provisions are sometimes referred to as the "moral hazard" provisions contained in the Pensions Act 2004, Sections 38 to 51.

Note 2: The universe of those "connected or associate" will include:

– anyone in the same corporate group as the employer, and

– anyone who can control directly or indirectly at least one-third of the voting rights in general meeting of the employer.

[5] Subsequent to the Pensions Act 1995 a number of substantial changes have been made to the regulatory regime for UK occupational defined benefit pension schemes. See, for example, the Pensions Act 2004.

[6] i.e. the cost of securing the scheme's benefit obligations with an insurance company.

[7] See Section 75 of the Pensions Act 1995 and the Occupational Pension Schemes (Employer Debt) Regulations 2005.

3. Mandatory revaluation of deferred pensions and indexation of pensions in payment

3.1 In addition, partly as a result of the substantial pension scheme surpluses from the mid-1980's, through to approximately the mid-1990's, UK legislation requires:

(a) mandatory revaluation of deferred pensions in respect of the pre-retirement period[8], and

(b) mandatory indexation of pensions once in payment[9].

3.2 In other words, there is no ability to reduce the level of revaluation of the pension in deferment or to reduce the level of increase of the pension in payment as a way of "flexing" downwards the benefits where the results of a valuation show a deficit.

4. The consequences of these changes

The consequences of the changes referred to above is that, employers offering defined benefit pension schemes, found themselves in the situation where all the risk had, over time, been shifted to the employer.

5. A contrast with the original allocation of risk when a defined benefit occupational pension scheme was set up in the UK

5.1 By way of contrast, in the pre-Pensions Act 1995 era a relatively common approach in the UK, in defining the legal relationship for creating defined benefit pension rights, was as follows:

(a) **Step 1**: The employer and the employee enter into an employment contract which provides that:

(i) the employee is eligible to become an active member of the employer's defined benefit pension scheme (established under trust), and

(ii) all other legal rights and obligations in relation to the legal relationship (including rights to terminate employer contributions and to amend benefits and contributions) would all be regulated by the terms of the trust deed and rules[10] governing the scheme.

[8] See the Pension Schemes Act 1993, Sections 83 to 86 and Schedule 3 (to be amended by the Pension Schemes Act 2015) requiring revaluation of the deferred pension over the number of complete years in the deferment period in line with the increase in inflation (measured using the inflation on the September on September inflation index (currently using the Consumer Prices Index), applicable, in general, for anyone whose defined benefit pensionable service ends after 31st December, 1990, capped at the rate of 5% compound (but excluding any pensionable service after 5th April, 2009) and for such pensionable service from 6th April, 2009 capped at 2.5% compound.

[9] See the Pensions Act 1995, Sections 51 to 54. Depending on the period of pensionable service in question, the required rate of increase to the defined benefit pension in payment is an increase each year in line with the September on September increase in the index measuring inflation (now using the increase in the Consumer Prices Index) capped at 5% (for defined benefit pension attributable to pensionable service in the period from 6th April, 1997 to 5th April, 2005) or 2.5% in respect of such pensionable service after 5th April, 2005.

[10] Terminology in the UK is that the benefit and member contribution provisions are normally contained in a set of "rules" appended to the pension schemes' trust deed (which is the document which establishes the trust and which sets out provisions dealing with matters, such as the appointment and removal of the trustees, trustee decision-taking and the way in which the pension scheme is to be administered (and its assets invested as well as regulating, at least originally, the winding-up of the scheme)).

(b) **Step 2:** The employer would have executed a trust deed and rules (along with the trustee of the scheme) which would set out:

(i) the terms and conditions on which the employer and employee contributions were determined,

(ii) the way in which the assets of the trust could be invested,

(iii) the benefits to be provided from the assets of the trust,

(iv) the circumstances in which the employer could amend the trust deed and rules (whether with or without trustee consent and whether with or without a restriction), and

(v) making provision for winding-up of the trust in certain circumstances (including insolvency of the employer and if the employer gives notice to wind-up the trust).

5.2 It was (and is) quite common, in my experience, for the trust deed and rules to provide that the employer could, by notice to the trustee, terminate its obligation to contribute to the trust without any obligation to make good any deficit[11] arising on the winding-up of the trust between the assets available and the benefits promised under the trust deed and rules.

5.3 The assets of the scheme would then be applied in a specified priority order to provide benefits for the members of the scheme at the time the winding-up started, with any shortfall between the cost of securing the benefits with an insurance company and the assets being made good by abating the benefits at the relevant priority level until the liabilities were in balance with the available assets at that priority level.

5.4 In other words, the well advised employer, in terms of management of legal risk in respect of a very long-term commitment, would have, in general, established its legal relationship with the employee in respect of retirement benefits in a way such there was a legal safety valve if the future did not unfold as assumed when determining the contributions required to fund the defined benefit pension scheme when it was set up.

5.5 That is not to say that some pension scheme trust deeds are not written on a basis which impose more stringent obligations on the employer (e.g. to contribute on wind-up) or which prevented amendments being made without employee consent[12].

[11] No longer effective, because of the statutory debt on the employer regime imposed by Section 75 of the Pensions Act 1995 (as amended).

[12] *Lloyds Bank Pension Trust Corporation v Lloyds Bank plc* [1996] PLR 263.

6. The economic environment in which defined benefit schemes were established in the 1970's to the 1990's

6.1 The UK was, during much of this period, a high inflation economy. That meant that the real value of the "nominal" defined benefit pension promise was constantly being eroded by inflation.

6.2 At the same time, nominal interest rates were high (to protect the lender against the depreciation in the lender's principal amount lent to the borrower) – in terms of aiming to maintain its value after adjustment for the effect of inflation and allowing the lender to obtain a return on its loan.

6.3 For example, **Table 1** below sets out interest rates on 10 year UK fixed interest gilts[13] in the period from 1990 to 2014 (along with the measure of inflation).

Table 1

		10-year redemption yield on fixed interest UK gilts as at 31st December each year (%)	Annual increase in the Retail Prices Index average for December of each year (%)
1.	1990	10.81	7.1
2.	1995	7.42	3.6
3.	2000	4.88	0.5
4.	2005	4.10	0.7
5.	2010	3.39	5.1
6.	2014	1.75	0.3

Sources: Bloomberg UK Generic Government 10-year Yield Index; Office for National Statistics

6.4 As a mechanism for seeking to guard against the effect of inflation, UK pension funds tended to invest very substantially in equities (which would better respond to a high inflation environment compared to fixed interest bonds).

6.5 It was this mis-match between investing in equities combined with the fall in inflation which led to the substantial surpluses in UK pension funds in the mid-1980's to the mid-1990's.

6.6 Because of the impact of inflation on the purchasing power of pensions in payment, it was not unusual for employers to fund the pension scheme on the basis that there was an allowance for providing discretionary (but not guaranteed) pension increases.

[13] i.e. UK Government bonds.

6.7 A particular discretionary increase, once granted, could not, for tax reasons, be discontinued. But, there would, if the discretionary increase was correctly described, not be any legally binding obligation on the employer to grant (and to pay for) discretionary increases in the future[14].

6.8 However, over time, as noted in **2.** and **3.** above, the employer safety valve for managing the risk of changes in the economic and business environment was removed and, ultimately, eliminated, so far as past service benefits were concerned[15].

B. THE MOVE TO DEFINED CONTRIBUTION PENSION SCHEMES

1. For reasons noted in **Section A** above, employers took steps to mitigate the risk in relation to providing defined benefit pensions.

2. That mitigating action took the following forms:

   2.1 to close the defined benefit pension scheme to new employees.

   2.2 to reduce or discontinue the level of benefits for future accrual in the defined benefit scheme for existing employees.

   Note: In addition, employee contributions could also be increased.

   2.3 to provide future service benefits only on a money purchase basis (where the employer had certainty of contributions and the employee had the uncertainty of the level of retirement income that the invested contributions could provide)[16].

3. As those low or medium income employees with retirement benefits being provided (wholly or in part) on a money purchase basis have started to approach retirement, the level of retirement income that could be provided with the member's money purchase retirement savings was not what the employee was expecting (and, in an increasing number of cases, has not been sufficient to enable the employee to be able to retire).

[14] For example, of a case where discretionary pension increases were discontinued – see ***Prudential Staff Pensions v Prudential Assurance*** [2011] EWHC 960.

[15] In principle, there is no reason why the power of amendment to the trust deed cannot provide for accrued benefits to be amended to balance the books. However, the ability to do this was removed by Section 67 of the Pensions Act 1995, which came into force on 6th April, 1997 which, in summary, said that amendments which adversely affected accrued rights (measured, for active members, on a leaving service basis) were void or, if made after 5th April, 2006 voidable.

[16] In the UK, in general, money purchase and defined contribution mean the same thing. For a definition of money purchase benefits, see Section 180 of the Pension Schemes Act 1993, as amended. The term "defined contribution" did not appear in UK pensions legislation until the Pension Schemes Act 2015 (see Section 4 of that Act).

4. It was, in general, prior to 6th April, 2015, a requirement that the member applied his or her money purchase retirement savings account to purchase an annuity at retirement (after withdrawing a cash lump sum of 25% of the member's retirement account subject to a maximum, as at 6th April, 2015, of, in general, £312,500)[17]. The cash lump sum is, in general, tax-free.

5. A consequence of low long term interest rates is that the cost of purchasing an annuity from an insurance company has increased (because, at least in part, the insurance company is going to seek to match its liability to pay the annuity with Government or other high quality bonds of the appropriate duration),

6. However, the requirement to purchase an annuity with a member's retirement savings account at the time of retirement has been relaxed with effect from 6th April, 2015[18].

7. These changes allow an individual to draw each year as much or as little of his or her money purchase retirement savings from the tax approved pension scheme and also provide the opportunity for the member to out-live his retirement savings.

C. PROPOSALS FOR COLLECTIVE BENEFIT SCHEMES

1. Against this background, the proposal for collective benefit schemes came out of a UK Department for Work and Pensions consultation paper "Reshaping workplace pensions for future generations" published on 7th November, 2013[19].

2. My partner, Sandy Maudgil, and I were involved in making a submission to the Department for Work and Pensions which looked at some the legal constraints, within the UK context which we suggested could usefully be addressed by any proposed legislation to enable collective benefit schemes to be set up.

3. For readers with an interest in some of those legal issues, the copy of the index to this paper (dated 9th June, 2014) is attached at **Appendix A** to this document. The full text of the paper is available at: http://www.slaughterandmay.com/media/2168140/amendments-to-uk-legislation-required-to-enable-defined-ambition-pension-schemes-to-be-set-up.pdf

4. As a word of warning, we had originally envisaged that this type of scheme would be called a "defined ambition scheme" (see the paper at **Appendix A**).

[17] In summary a member of a tax-approved (or registered) pension scheme has a lifetime allowance of, with effect from 6th April, 2015, £1,250,000. The member may receive, in respect of his retirement savings (whether they are in money purchase or defined benefit form) from registered pension schemes, a tax-free lump sum which is, in general, equal to one-quarter of the value of those retirement savings subject to a maximum amount of one-quarter of his lifetime allowance (i.e. £312,500).

[18] See the Taxation of Pensions Act 2014.

[19] Cm8710.

5. Following the consultation (see **1**. above), the UK Government announced, via the Queen's speech to Parliament on 4th June, 2014, a proposal for legislation which would enable "collective schemes" to pool risk between members and potentially allow for more stability around pension outcomes for retirement.

6. We understand that the then Pensions Minister (Steve Webb) had decided that the term "defined ambition scheme" should apply to what would, more logically, have been called "shared risk schemes" (i.e. where there is an element of some part of the benefit being guaranteed with the employer being liable for the shortfall on funding in respect of that benefit with other benefits in the scheme being ones where the risk of the target benefit being achieved or the target benefit aspiration being achieved being for the account of the scheme member).

7. As a matter of terminology, the new legislation in this area distinguished between:

   7.1 defined ambition schemes (more accurately called shared risk schemes), where there is a sharing of risk between employer and employee and there is some guarantee on part of the member's benefits, and

   7.2 collective benefit schemes which pool risk between members and potentially provide for greater stability around pension outcomes but with the employer not having any obligation to make up any shortfall in the scheme.

8. The Pension Schemes Act 2015 received Royal Assent on 3rd March, 2015 and sets out the legislative framework for allowing collective benefit schemes to be established in the UK.

9. Although the Pension Schemes Act 2015 refers to schemes which provide "collective benefits", the more usual terminology, at present, in the UK is to refer to this type of scheme as a "collective DC scheme" or a "CDC scheme".

D. CURRENT STATE OF PLAY IN RELATION TO THE ESTABLISHMENT OF COLLECTIVE BENEFIT SCHEMES IN THE UK

1. Although the primary legislation has passed through Parliament (with effect from 3rd March, 2015), a lot of detail is still to be filled in by regulation.

2. In other words, we have the "skeleton" but we are waiting for the "flesh to be put on the skeleton" via the Regulations contemplated by the Pension Schemes Act 2015.

3. **Section E** below looks at the legal framework for collective benefit schemes as set out in the Pension Schemes Act 2015.

E. LEGAL FRAMEWORK FOR COLLECTIVE BENEFIT SCHEMES IN THE UK AS SET OUT IN THE PENSION SCHEMES ACT 2015

Warning note: What follows is based on the Pension Schemes Act 2015 and on what Regulations to be made under the Pension Schemes Act 2015 are likely to say on the issues covered in this Section. As at the time of writing (11th May, 2015), there are no Regulations.

1. Definition of "collective benefit"

1.1 Section 8 of the Pension Schemes Act 2015 contains a definition of "collective benefit"[20].

1.2 The definition of "collective benefit" is as follows:

"*A benefit is a "collective benefit" if in all circumstances the rate or amount of the benefit depends entirely on-*

(a) the amount available for the provision of benefits to or in respect of the member and one or more other members collectively, and

(b) the factors used to determine what proportion of that amount is available for the provision of the particular benefit."[21]

2. Funding issues for collective benefit schemes

2.1 Duty to set targets[22]

(a) The trustee[23] of the scheme will have a duty to set targets in relation to the collective benefits provided by the scheme (including initial targets at a level which ensures that the probability of meeting the targets falls within a range to be specified in Regulations).

(b) There is to be a requirement for an actuary appointed by the trustee to provide a certificate that the initial targets will have been set at a level that complies with the probability range requirements to be specified in the Regulations to be made under the Pension Schemes Act 2015.

[20] A scheme which provides collective benefits is called, in this paper, a collective benefit scheme. However, there is no definition of "collective benefit" scheme as such in the Pension Scheme Act 2015. Instead the legislation refers to a scheme which provides collective benefits.

[21] See Section 8(2) of the Pension Schemes Act 2015.

[22] See Section 9 of the Pension Schemes Act 2015.

[23] The Act also refers to "managers" (and see Section 35(1)) and contemplates the possibility that a collective benefit scheme could be established, otherwise than under trust (e.g. as a contractual arrangement by an insurance company). References to trustee in the rest of this paper should be read accordingly. That said, the writer's current expectation is that schemes of this type will be set up under trust.

2.2 Policy on factors[24]

The trustee will be required to have a policy about factors to be used for what proportion of the amount available for the provision of collective benefits by the scheme is to be available for the provision of a particular collective benefit (and to follow that policy in calculating the collective benefit).

2.3 Schedule of payments[25]

(a) There will be a requirement for a schedule of payments to specify the contributions to be paid to the scheme by the employer (and, where applicable, employees).

(b) Overdue contributions would become a statutory debt to be enforceable by the trustee against the employer[26].

3. Statement of investment strategy[27]

The trustee would have an obligation to prepare a statement of investment strategy to indicate the strategy for investing the scheme's assets with a view to providing the collective benefits which have been targeted.

4. Duty to obtain valuations[28]

4.1 The trustee would have a duty to obtain periodic valuation reports prepared by the scheme actuary:

(a) valuing the assets of the scheme held for the purposes of providing collective benefits, and

(b) assessing the probability of the scheme assets being sufficient to meet the targets in relation to those benefits.

4.2 The Regulations may make provision about the methods or assumptions to be used by the scheme actuary in valuing these assets or assessing the probability of the assets being sufficient to enable the scheme to meet the targets for the collective benefits.

5. Deficit/surplus policy[29]

5.1 The trustee would be required to have a policy for dealing with a deficit or surplus in respect of any collective benefits (and to follow that policy if a valuation report shows a deficit or surplus).

[24] See Section 10 of the Pension Schemes Act 2015.
[25] See Section 12 of the Pension Schemes Act 2015.
[26] See Section 13 of the Pension Schemes Act 2015.
[27] See Section 14 of the Pension Schemes Act 2015.
[28] See Sections 19 and 20 of the Pension Schemes Act 2015.
[29] See Section 21 of the Pension Schemes Act 2015.

5.2 In this context, there would be a "deficit" in respect of a collective benefit[30] if the probability of the scheme meeting a target in relation to that benefit is below the required range.

5.3 There would be a "surplus" in respect of a collective benefit if the probability of the scheme meeting a target in relation to the benefit is above the required range[31].

6. Transfer value policy[32]

6.1 The trustee would be required to have a policy for calculating transfer values (also referred to as the "cash equivalent" of any collective benefit that may be provided by the scheme).

6.2 Under the Pension Schemes Act 1993[33], deferred members of an occupational pension scheme have a statutory right to transfer the "cash equivalent" of their benefits in the scheme. In the case of defined benefits, this requires an actuarial calculation to come up with a capital value of the defined benefit benefits. In the case of money purchase benefits, the amount to be transferred is the realised value of the investments backing the member's money purchase benefits.

7. Policy about winding-up[34]

7.1 The trustee may be required under the proposed Regulations to have a policy about winding-up the scheme along with the requirement to follow that policy.

7.2 In addition, Regulations may provide specifically for the circumstances in which the trustee would be required to wind-up the scheme.

8. Governance requirements in relation to a scheme which provides collective benefits

8.1 The Pension Schemes Act 2015 makes no specific provision as to the governance requirements in relation to a scheme which provides collective benefits.

8.2 However, the Pension Act 2004[35] lays down a requirement for at least one-third of the trustee board to be member-nominated, unless there is an independent trustee.

8.3 Where non-associated employers may participate in a scheme which provides collective benefits, it is highly likely that additional governance requirements will apply[36].

[30] See Section 21(2) of the Pension Schemes Act 2015.
[31] See Section 21(2) of the Pension Schemes Act 2015.
[32] See Section 25 of the Pension Schemes Act 2015.
[33] See Sections 93 to 101 of the Pension Schemes Act 1993.
[34] See Section 28 of the Pension Schemes Act 2015.
[35] See Sections 241 to 243 of the Pensions Act 2004.
[36] This would follow by analogy to the enhanced governance requirements, which came into force on 6th April, 2015, in the Occupational Pension Schemes (Charges and Governance) Regulations 2015 (for certain types of schemes which provide money purchase benefits).

9. Liability of the employer in respect of a scheme which provides collective benefits

The Pension Schemes Act 2015 switches off the following provisions that impose liability on an employer in relation to a defined benefit occupational pension scheme:

9.1 the employer debt regime in Section 75 of the Pensions Act 1995[37],

9.2 the contribution notice and financial support direction regime in Sections 38 to 51 of the Pensions Act 2004[38],

9.3 the funding regime in Part 3 of the Pensions Act 2004[39].

Comment 1: It is essential that the way in which a collective benefit is defined is such that it does not fall within the requirements of Article 15(2) of Directive 2003/41/EC, which applies to a scheme which provides "*cover against biometric risks and/or guarantee[s] either an investment performance or a given level of benefit*" to establish sufficient technical provisions.

Comment 2: If the collective benefits were to fall within Article 15(2) of this Directive, then that would bring collective benefits within the funding regime provided for in Article 16 of the Directive and within the additional funding regime which applies to "*regulatory own funds*" in Article 17 of the Directive.

Comment 3: This point is covered in more detail in the paper at Appendix A.

10. Revaluation of collective benefits and increases to collective benefits in payment

10.1 The Pension Schemes Act makes provision for the collective benefits of a deferred member of a collective benefit scheme to be revalued in the same way as if the member had not ceased to be an active member. In other words, there is to be no discrimination on revaluation as between an active member and deferred member[40].

10.2 But, equally, there is no requirement to provide any guaranteed level of revaluation in deferment if there is no requirement for to provide a guaranteed level of revaluation to the benefits accruing for the active member.

Note: This is consistent with the concept of a member of the collective benefit scheme accumulating a series of "retirement bricks". In simplified terms these can be viewed as a "brick" purchased for each year of active membership with each "brick" having attached to it its own target level of preserving

[37] See the Pension Schemes Act 2015, Schedule 2, paragraph 12.
[38] See the Pension Schemes Act 2015, Schedule 2, paragraphs 27 and 28.
[39] See the Pension Schemes Act 2015, Schedule 2, paragraph 32.
[40] See, more generally, the Pension Schemes Act 2015, Schedule 1 introducing new Section 84B into the Pension Schemes Act 1993 and the amendment to Schedule 3 to that Act, paragraph A1.

its purchasing power in the pre-retirement period and its own target level of preserving its purchasing power after the date as at which the member is assumed to bring that retirement "brick" into payment.

10.3 There is no requirement to provide any level of guaranteed pension increase for a collective benefit. The requirements of Sections 51-54 of the Pensions Act 1995 are switched off by Section 41 of the Pension Schemes Act 2015.

11. Management of "reclassification risk"/change of law risk

11.1 One of the concerns for employers is that a regime which starts out with a low level of legal and financial risk for the employer is changed by the courts or by subsequent governments into one which transfers all or most of that risk back to the employer.

11.2 With careful drafting, it should be possible to manage what may be viewed as "reclassification risk" by the courts.

11.3 However, as Parliament is supreme, the risk of legislative change cannot be ruled out.

11.4 Furthermore, the risk of change which emanates from Brussels via Directives or Regulations, likewise, cannot be ruled out. That said, Directives and Regulations tend to have a substantial lead time.

11.5 In relation to UK and European Union legislation there is scope for a drafting solution (not foolproof, but with a reasonable level of safeguard) based on a provision for automatic conversion of collective benefits into money purchase benefits immediately before a trigger event which would impose additional liability on the employer.

11.6 That said, the suggestions contained in the paper at **Appendix A**, for management for legal risk to the employer by having the Pensions Regulator issue a certificate that was conclusive as to the status of the scheme's benefits were not adopted in the Pension Schemes Act 2015.

12. Age discrimination

12.1 It will be important for there to be a clear safe harbour from age discrimination related claims in respect of collective benefit scheme design.

12.2 The Equality Act (Age Exceptions for Pension Schemes) Order 2010, Schedule 1, contains the following principal exceptions for defined benefit and money purchase benefits:

(a) the use of age criteria in actuarial calculations is permissible (see paragraph 2 of Schedule 1), but is limited to determining the level of member or employer contributions, early and late retirement factors and factors for converting a pension into a lump sum.

(b) in respect of money purchase arrangements, it is permissible to have:

(i) different rates of employer contributions according to the age of members where the aim in setting the different rates is:

(A) to equalise the amount of the retirement benefit in respect of comparable aggregate periods of pensionable service to which members of different ages, who are otherwise in a comparable situation, will become entitled under the arrangement, or

(B) to make more nearly equal the amount of the retirement benefit, in respect of comparable aggregate periods of pensionable service, to which members of different ages who are otherwise in a comparable situation will become entitled under the arrangement, or

(ii) equal rates of employer contributions irrespective of the age of the member in respect of whom the contributions are made.

(See Schedule 1, paragraph 4).

(c) where different rates of employer contributions are payable by the employer according to the age of the members in respect of whom those contributions are made, to the extent that:

(i) each year of pensionable service entitles members in a comparable situation to accrue a right to defined benefits based on the same fraction of pensionable pay, and

(ii) the aim in setting the different rates is to reflect the increasing cost of providing the defined benefits in respect of members as they get older.

(Schedule 1, paragraph 5).

12.3 An exception along the lines available for defined benefit and money purchase arrangements, as outlined in 12.2 above, would be needed (but should follow logically from the available exemptions for money purchase benefits and defined benefit benefits, as noted above).

F. ADVANTAGES OF COLLECTIVE BENEFIT SCHEMES

1. The case for collective benefit schemes is that they should, on average, provide members of such schemes with a greater level of retirement income (something in the region of 20-25%[41] (possibly more) with a lower level of volatility in terms of range of out-turns for any particular member).

[41] Paper (July, 2012) by David Pitt-Watson and Hari Mann for the Royal Society of Arts entitled "***Collective Pensions in the UK***", and the Government Actuary's Department paper "***Modelling Collective Defined Contribution Schemes***" (published December, 2009) and the Aon Hewitt White Paper "***The Case for Collective DC***" prepared by Kevin Wesbroom, David Hardern, Matthew Arends and Andy Harding (published November, 2013).

2. This improvement in the level of retirement income is said to be achieved:

   2.1 in part, through the ability to invest with longer time horizons in growth assets than any individual member (particularly in the de-accumulation period post-retirement) could sensibly choose,

   2.2 in part, through the savings achieved by not buying an annuity (regulatory capital cost and profit margin), and

   2.3 in part, through the overall reduction in costs achieved through the economies of scale.

3. However, the risk sharing needs to be managed with care to avoid older generations ending up with greater benefits than, with hindsight, they should have ended up with (but with the benefit having been paid out no ability to clawback the benefit).

4. A point to draw out is that if a contribution rate to a money purchase scheme is at the same percentage of pensionable pay for, for example, a 25 year old employee and a 64 year old employee, the amount of retirement income generated by that contribution (assuming both employees are on the same level of pensionable pay) will, after allowing for inflation, be very substantially higher for the 25 year old.

5. In contrast, in a defined benefit scheme, 1 year's accrual of defined benefit pension for a 25 years old costs substantially less than 1 year's accrual for a 64 year old.

6. Depending on the design of the target benefit to be provided under a collective benefit scheme, the same cost differential can arise as in a defined benefit scheme.

7. It is also possible that, in the UK context, a collective benefit scheme may also become attractive as a "de-accumulation option" for those with money purchase benefits who are moving into retirement.

8. Such a collective benefit scheme could offer:

   8.1 a higher level of predictability of retirement income and protection against outliving the individual's retirement savings than income drawdown by the member from his or her retirement savings[42], but

   8.2 at a lower cost than purchasing the certainty of a guaranteed level of retirement income for life from an insurance company by way of an annuity (but with the associated certainty of that retirement income being at a substantially lower level than that provided under the collective benefit scheme).

[42] Because, with effect from 6th April, 2015, there is no longer a requirement to purchase an annuity and the individual is not constrained as to the rate at which he or she may drawdown those retirement savings.

G. COLLECTIVE BENEFIT SCHEMES IN THE UK: NEXT STEPS

1. During the previous Parliament (which ended just before the UK General Election on 8th May, 2015), the 2 main political parties (the Conservative party and the Labour party) along with the Liberal Democrat party (the coalition partner with the Conservative party in that Parliament), all expressed themselves to be in favour of collective benefit schemes.

2. The then Pensions Minister, Steve Webb, is on record as saying the following in relation to collective benefit schemes:

   "*Collective schemes will provide more stability for savers, while the Budget changes will provide more control for people when they draw their savings. We will not be delivering boxed versions of Dutch or Canadian models straight into the British Market. That makes no sense. We need to introduce what works best for British business and workers.*"[43]

3. Similarly, the Shadow Pensions Minister, Gregg McClymont, said:

   "… *the Government are attempting – we welcome the attempt, not least because we have been arguing for it – to pool and share risk long term across generations. In doing so, they are reflecting a developing political consensus around the importance of sharing risk as widely as possible in the pension sphere. [ ] think that there is a developing consensus that that is a good thing, and in so far as it promotes collective defined contributions, the Bill is welcome.*"[44]

4. However, in the General Election on 8th May, 2015, both the Pensions Minister (Steve Webb, Liberal Democrat) and the Shadow Pensions Minister (Gregg McClymont, Labour) lost their seats (with the associated loss of expertise at Minister/Shadow Minister level in relation to collective schemes).

5. At this stage it is too early to say whether the new Conservative Government will take forward the legislative process under which the Regulations contemplated by the Pension Schemes Act 2015 are prepared and brought into force in good time to enable collective benefit schemes to be established by 6th April, 2016.

6. The significance of 6th April, 2016 is that this is the date on which there will be a major change to the UK State Pension Scheme.

7. It will also be the date with effect from which contracting-out rebates (provided by the Government to employers who still offer defined benefit pension schemes which provide a minimum level of benefit to contract-out of the UK Second State Pension Scheme) will cease to be available.

[43] Letter to the Daily Telegraph (7th June, 2014).
[44] On 2nd September, 2014, in the House of Commons debate on what is now the Pension Schemes Act 2015.

8. That change will cause employers still offering defined benefit schemes which provide future accrual to re-evaluate the continued provision of those defined benefits for future service.

9. It should be noted that there are some commentators in the UK who have suggested that this type of scheme is a type of "Ponzi con trick[45]".

10. However, for a contrary view, see the article in the Economist "Not Ponzis, but pyramids[46]".

11. It should also be noted that the way in which a collective benefit scheme would be treated for:

    11.1 annual allowance purposes, and

    11.2 lifetime allowance purposes,

    under the tax regime set out in the Finance Act 2004 (as amended) for UK tax approved pension schemes is yet to be settled (further detail on this is explained in the paper attached at **Appendix A**).

Philip Bennett, Partner, Slaughter and May **11th May, 2015**

[45] See the article in the Financial Times by John Ralfe of 15th June, 2014.
[46] Buttonwood's Notebook – 16th June, 2014.

APPENDIX A

Updated from the version of 28th March, 2014 for comments received in APL Workshops held on 13th May, 2014 and 19th May, 2014 and the announcement in the Queen's speech on 4th June, 2012 of the Private Pensions Bill to enable collective DC schemes

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Amendments To UK Legislation Required To Enable Defined Ambition Pension Schemes[47] To Be Set Up

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9th June, 2014

Slaughter and May
One Bunhill Row
London EC1Y 9YY

Ref: PFJB/SZZM

528664375

[47] These schemes could also be referred to as target benefit schemes or collective DC schemes.

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The full text of this paper is available at http://www.slaughterandmay.com/media/2168140/amendments-to-uk-legislation-required-to-enable-defined-ambition-pension-schemes-to-be-set-up.pdf

London
One Bunhill Row
London EC1Y 8YY
United Kingdom

T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Brussels
Square de Meeûs 40
1000 Brussels
Belgium

T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong
47th Floor, Jardine House
One Connaught Place
Central
Hong Kong
T +852 2521 0551
F +852 2845 2125

Beijing
2903/2905 China World Office 2
No.1 Jianguomenwai Avenue
Beijing 100004
People's Republic of China
T +86 10 5965 0600
F +86 10 5965 0650

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