EXPLANATORY MEMORANDUM TO THE

PENSION PROTECTION FUND (COMPENSATION) REGULATIONS 2005

2005 No.670

1. This explanatory memorandum has been prepared by the Department for Work and Pensions and is laid before Parliament by Command of Her Majesty.

2. **Description**

2.1 The Board of the Pension Protection Fund ("PPF") is established by section 107 of the Pensions Act 2004 (c.35) ("the Act") to provide compensation for members of eligible occupational pension schemes in the event of the insolvency of the scheme's sponsoring employer and where the pension scheme is underfunded at a certain level.

2.2 The various elements of compensation are provided within Schedule 7 to the Pensions Act and enable members and their beneficiaries to receive compensation in accordance with a mixture of their scheme rules and Pension Protection Fund rules.

2.3 These regulations provide detail for various elements of compensation of Schedule 7 to the Pensions Act 2004 including early payment of compensation, survivors' compensation, admissible rules, revaluation, short term members, commutation, compensation cap modifications, definitions of pre and post-1997 service and cash balance schemes.

3. **Matters of special interest to the Joint Committee on Statutory Instruments**

3.1 None.

4. **Legislative Background**

4.1 This is the first use of the powers under paragraphs 4, 6, 9, 12, 13, 16, 17, 18, 20, 23, 24, 25, 26, 28, 31 and 33 of Schedule 7 of the Pensions Act 2004.

4.2 These regulations are required from 6th April 2005 to ensure they will apply to any scheme which may enter an assessment period after this date.

5. **Extent**

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

6.1 Not applicable.

7. Policy Background

7.1 The Pensions Act establishes the Pension Protection Fund (PPF). The PPF will pay compensation to members of eligible schemes where the sponsoring employer is insolvent and the scheme has insufficient assets to pay benefits at a level at least equal to the amount of compensation the PPF would provide.

Early Payment of Compensation

7.2 Paragraph 25 of Schedule 7 of the Pensions Act 2004 provides for members to take early payment of compensation, subject to actuarial reduction.

7.3 These regulations provide that early payment of compensation is available, subject to at least six months advance application, from age 50. The six months notice requirement can be waived by the Board if it considered that the notice period would cause hardship to the member.

7.4 These regulations exclude pension credit members from accessing early payment of compensation to maintain consistency with provisions in the Pension Schemes Act 1993 (inserted by the Welfare Reform and Pensions Act1999 Act) and the Pension Credit Benefit Regulations which require that a pension by periodic payments is only payable to a pension credit member of an occupational pension scheme once they have reached 'normal benefit age'. Section 315 [Subordinate legislation general provisions] of the Pensions Act 2004 also supports specified exceptions.

7.5 The regulations also prevent members from accessing early payment of compensation during the assessment period. This is to prevent members from accessing and receiving a pension that they would not have entitlement to under their scheme rules, should their scheme be rescued during an assessment period.

Benefits for Survivors

7.6 Paragraphs 4, 6, 9, 13 and 18 of Schedule 7 of the Pensions Act 2004 provide for compensation to be payable to surviving spouses, with certain exclusions.

7.7 These regulations provide that where a scheme has no provision to pay surviving spouses, then PPF compensation will not be payable. This policy ensures that the PPF will not be more generous than schemes and ensures equality with the provisions for surviving unmarried partners and civil partners.

7.8 Paragraph 23 provides for compensation to be payable to certain survivors in prescribed circumstances. These regulations provide that, subject to satisfying PPF rules, compensation will be payable to surviving unmarried partners where there was provision (including discretionary provision) to pay unmarried partners under the scheme rules. The regulations set the criteria that must be met for an individual to be considered as an unmarried partner (for example, that the survivor must have been living with and financially dependant on the member at the date of death) and places a requirement on the individual to prove that they meet these criteria.

7.9 Under these regulations an unmarried partner can be of either sex, and may be in an opposite sex or same sex relationship.

7.10 These regulations provide that under paragraph 23 of Schedule 7 of the Pensions Act, the rate of compensation payable to surviving unmarried partners will be half of the deceased member's periodical compensation entitlement (which will vary according to the status of the pension status of the member at his time of death). This rate mirrors the rate of compensation payable to surviving spouses to ensure fairness.

7.11 Regulations under paragraph 23 of Schedule 7 also provide that compensation will be payable for all surviving dependants who are; natural children, adopted children or any other children financially dependant on the member at their date of death. Compensation will usually be payable to age 18. This policy mirrors provisions of the majority of schemes.

7.12 These regulations also provide that compensation payable under paragraph 23 of Schedule 7 can be extended for surviving dependant children from age 18 to age 25 providing certain conditions are met. These conditions include a requirement for the dependant to be in full time education or vocational training, or to be incapable of engaging in full time employment due to a condition that falls within the definition of a disability under the Disability Discrimination Act 1995. This policy mirrors the majority of scheme rules.

7.13 These regulations also provide that under paragraph 23 of Schedule 7 of the Pensions Act, the rate of compensation payable to surviving dependants will be between 25% and 50% depending upon whether compensation is in payment to a surviving spouse or partner and whether there is more than one child. These regulations ensure that the compensation payable to survivors will not exceed 100% of the deceased member's entitlement and matches the provisions of the majority of schemes.

7.14 Where there is a change to the survivors' circumstances, for example, the surviving dependant leaves full time education to start work or the surviving partner dies, these regulations provide that the compensation payable will be adjusted to take account of the change of circumstances from the date the change occurred. This ensures that payments to survivors accurately reflect their circumstances in accordance with the PPF rules.

7.15 These regulations provide that a backdating time limit of 5 years will apply for late applications for compensation from survivors. This is in line with the approach taken by occupational pension schemes.

Admissible Rules

7.16 The amount of compensation payable by the PPF to scheme members depends, to a large extent, on the rules of their scheme. However, when calculating compensation, the PPF cannot use the scheme rules exactly as they stand. Instead they must consider all rule changes and changes to the rate of pensions in payment or postponed pensions in the three years prior to the assessment date. If the effect of these changes was to increase the overall liabilities of the scheme they are disregarded. The rules that are left are known as the "admissible rules" and it is these rules that are used for calculating PPF compensation. This process is required by paragraph 35 of Schedule 7 to the Act. The purpose of this policy is to prevent schemes from changing rules when insolvency is likely, in the expectation that the PPF will foot the bill for the increase in liabilities.

7.17 Where scheme rules are disregarded the preceding rule will automatically apply – this means it is possible that the effect of applying the admissible rules is that an individual who was in receipt of a pension does not have any entitlement to compensation.

7.18 Application of the admissible rules could lead to some individuals, who were in receipt of a pension immediately before the assessment date, losing entitlement to compensation. These regulations set out what compensation individuals affected in this way will be entitled to:

- An individual who was previously in receipt of a survivor's pension will be treated as being entitled to present payment of the pension under the admissible rules i.e. they will continue to get the highest level of compensation. This is because schemes are unlikely to seek to take advantage of the PPF by increasing the number of individuals in receipt of survivors benefit (as this would first require the death of the member).
- Other individuals will be re-categorised as deferred members i.e. they lose entitlement to present payment of compensation but become entitled to compensation at the level paid to deferred members. In such circumstances, the regulations make specific provision to take account of any lump sum or commutation already taken. For example, if the member had already taken their separate scheme pension lump sum then the regulations ensure they will not be entitled to a second lump sum when they first become entitled to compensation.
- Where a member was in receipt of an ill health pension and the application of the admissible rules means they have no right to compensation (e.g. because they change the ill-health rules against which the member was assessed) then these regulations require the trustees or managers of the

scheme to reassess that individual under the admissible ill health rules. Once this has been conducted the result will need to be sent to the member and the Board of the PPF who may then review any award to make sure the proper process has been followed using their powers under section 140 and 141 of the Act. If a member does not satisfy the admissible ill health rules they will be re-categorised as a deferred member (see previous).

Revaluation

7.19 Paragraph 12 of Schedule 7 of the Pensions Act 2004 provides for revaluation to be payable on compensation for **active members** who are under normal pension age immediately before the assessment date.

7.20 Paragraph 17 of Schedule 7 provides for revaluation to be payable on compensation for **deferred members** who are under normal pension age immediate before the assessment date.

7.21 Revaluation is the name used for increases in pension between the time the member leaves the scheme and the start of their pension payment from the scheme. Revaluation is calculated at the point of retirement and ensures that the member receives a meaningful level of pension at retirement. Revaluation is provided on compensation by the PPF at Retail Prices Index (RPI) capped at 5%.

7.22 Revaluation of an **active member's** compensation is provided under paragraph 12 of Schedule 7 and relates to the period from the assessment date (when the active service was terminated) to the day before the member reaches normal pension age.

7.23 Revaluation of a **deferred member's** pension is provided under paragraphs 16 and 17 of Schedule 7 and relates to two periods; paragraph 16 relates to the day after the member left the scheme to the day before the assessment date and paragraph 17 relates to the period from the assessment date to the day before the member reaches normal pension age.

7.24 Revaluation under paragraphs 12 and 17, and the associated regulation, applies to the period from the assessment date to the day before the member reaches normal pension age. The associated regulations detail the formula to be used when calculating the revaluation percentage increase to be added to the member's compensation. Subject to the maximum level of revaluation, the percentage increase to be used in the calculation of the revaluation is the increase in the difference between the general level of prices in Great Britain at the assessment date and the level of prices at the point of retirement. General level of prices means the general index (for all items) published by the Office for National Statistics. If the general index is not published for the relevant month, any substituted index or index figures published by that office will be used. As the retail price index in respect of a particular date is not published until the following month, the calculation of the change in the retail price index is measured from the date two months before the date to which they relate. This ensures that members can start to be paid their compensation immediately from the date the compensation is due.

7.25 Paragraph 16 of Schedule 7 of the Pensions Act 2004 provides for determination of the revaluation amount for deferred members from the day after they leave the scheme (but retain rights in the scheme) to the day before the assessment date. Regulations provide that the revaluation amount will be calculated in accordance with the permitted rules of the scheme as, during this period, the scheme would still have been in existence and therefore PPF rules would not be applicable (revaluation is calculated at the point of retirement).

Compensation in respect of protected transfer payment or protected contribution repayment

7.26 Paragraph 20 of Schedule 7 of the Pensions Act 2004 provides for members to receive compensation where their pensionable service has been terminated because of the commencement of an assessment period, they have no Chapter 5 rights (statutory rights to a contribution refund or cash transfer payment), no rights under the scheme which give them the same level of benefits as those who stay in the scheme until the scheme's normal pension age, but the member does have a right under the permitted rules of the scheme to either, or a choice of, a contribution refund or a cash transfer payment

7.27 For information only, Chapter 5 provides that where a member leaves a scheme after 3 months, but doesn't have rights under the scheme which give them the same level of benefits as those who stay in the scheme until the scheme's normal pension age, then they will be entitled either to a cash transfer sum or a refund of their contributions. Although Chapter 5 rights commence in April 2006, regulation 4 provides that a member who would receive compensation under paragraph 20 of Schedule 7 shall be treated as if Chapter 5 were in force until Chapter 5 rights actually commence.

7.28 Where the member has a right under the permitted rules of the scheme to either, or a choice of, a contribution refund or cash transfer payment, then compensation will be payable at a level equivalent to 90% of the transfer payment sum or refund of contributions, whichever is the greater. The 90% level of compensation is in line with the standard PPF levels of compensation. The compensation will be calculated in accordance with the permitted rules of the scheme. Regulations under paragraph 20(4) determine that the refund of a contribution refund should be calculated by reference to the amount of contributions made by the employee. Further regulations under paragraph 20(4) determine that the refund of a cash transfer payment should be made by reference to the PPF formula: accrual rate x pensionable earnings x pensionable service (AR x PE x PS).

7.29 In addition, regulations under paragraph 20(4) of Schedule 7 to the Act provide that where the Board is unable to identify one or more of the elements of the PPF formula (AR x PE x PS) it may, having regard to the permitted rules of the scheme, determine how the transfer repayment is to be calculated. The purpose of this regulation is to provide the Board with the ability to calculate the compensation where it would otherwise be unable to do so.

7.30 Regulations prevent duplicate payments of compensation in respect of the same pensionable service to ensure that members are not overpaid compensation.

Commutation

7.31 Paragraph 24 of Schedule 7 of the Pensions Act 2004 provides for members who do not have a right under their scheme to a separate lump sum to opt to commute, i.e. swap, a portion of their regular pension compensation for a tax free lump sum.

7.32 These regulations provide that an application to exercise the option to commute must be made by the member within 6 months from entitlement arising or the transfer notice being issued by the Board to assume responsibility for the scheme, whichever is the later.

7.33 These regulations also provide that the Board can waive the requirement for 6 months notice in cases of hardship.

7.34 The regulations detail the information that must be included in any application for commutation. The member's request must include their name, address, date of birth, national insurance number and name of employer in relation to the scheme.

7.35 The maximum portion which can be commuted is 25%. However these regulations provide for 100% commutation of an individual's regular compensation on the grounds of triviality in accordance with the Finance Act 2004, i.e. where the total aggregate value of benefits payable to the member under all schemes providing benefits in respect of the same employment as the eligible scheme does not exceed the value of a pension of £260 per annum.

Compensation Cap Modifications

7.36The compensation cap provides a limit to the amount of compensation payable by the Board to those individuals who, under the terms of the Act, are eligible for 90% level of compensation (typically individuals under their scheme's normal pension age at the start of the PPF's involvement with a scheme). The purpose of the compensation cap is to encourage those who are higher earners, and therefore have influence over the scheme, to ensure the scheme does not enter the PPF. This is achieved by limiting the amount of compensation to a level of 90% and applying the compensation cap for the majority of members under normal pension age. The use of a compensation cap is one of a number of measures which helps to control the PPF expenditure to enable sustainability of the PPF.

7.37 Paragraph 26 of Schedule 7 of the Pensions Act 2004 provides that for individuals who are eligible for 90% level compensation, the amount payable is restricted if the annual value of the pension from which the compensation derives exceeds the amount of compensation cap, or if it does so when aggregated with the equivalent annual value of other benefits, for example, lump sums, from the scheme or connected schemes (for example, where the schemes fall under the same employer) in respect of which compensation is payable at the same time.

7.38 These regulations amend paragraph 26 to provide for the operation of the cap in complicated cases where compensation is paid by the Board in successive tranches (for example the move from a non-executive post to an executive post may result in two different tranches of entitlement to pension at two different scheme pension ages or where the rules of the scheme changed in the past and the member has some pension rights which commence at age 60 and some at age 65), or the person entitled to the compensation has on a previous occasion become entitled to one or more lump sums from the scheme in question or from connected schemes.

7.39 The restriction applies by aggregating the annual values of the former benefits or lump sums with the benefits payable in the latest tranche. This approach ensures that an individual does not receive compensation in respect of one scheme or connected schemes, which in aggregate, exceeds the compensation cap as this would undermine our policy intent as described in paragraph 7.2. We have adopted this approach because it is fair.

7.40 The regulations also provide that, when applying the compensation cap, any lump sums discharging liability for benefits of a relatively small amount can be disregarded if their payment does not contravene certain statutory rules or rules applied by the Inland Revenue in determining whether tax advantages apply to schemes and their benefits. These trivially commuted lump sums will not be subject to the compensation cap. In addition they will not be aggregated with other benefits in determining if the cap applies and what the amount of the cap is. We have decided to disregard trivial lump sums because, the amounts potentially involved are inconsequential and do not warrant the likely associated administrative costs.

Annual increase in periodic compensation: post-1997 and pre-1997 service

7.41 Indexation is provided under paragraph 28 of Schedule 7 of the Pensions Act 2004 and provides for compensation to be increased annually in line with the percentage increase in the retail prices index, capped at 2.5%. Indexation is payable on compensation derived from post 6th April 1997 pensionable service only.

7.42 These regulations provide under paragraph 28(6) of Schedule 7 to the Act, the meaning of pre 1997 and post 1997 service in relation to pensionable service i.e. actual service in any description of employment to which the scheme applies and which qualifies the member for benefits under the scheme, and permitted notional service.

7.43 These regulations provide that **pre 1997 service** means, in relation to paragraph 28(6) of Schedule 7 to the Act, service which is treated for the purposes of the scheme as occurring before 6th April 1997. This policy ensures that the PPF will mirror schemes.

7.44 The regulations provide that **post 1997 service** means, in relation to paragraph 28(6) of Schedule 7 to the Act, service which is treated for the purposes of the scheme as occurring on or after 6th April 1997. This policy ensures that the PPF will mirror schemes.

7.45 These regulations also provide the Board with discretion to determine pre and post 1997 service where there is uncertainty. This provides flexibility for the Board to make decisions where, for example, records may have been lost or destroyed.

7.46 Paragraph 28(7) of Schedule 7 to the Act provides regulations to define the meaning of pre and post 1997 service in relation to pension credit members (i.e. members whose pension derives from a pension sharing order made on divorce or nullity).

7.47 These regulations define **pre 1997 service** as being the pension credit rights which are derived from the member's pensionable service in the scheme which are attributable to service occurring prior to 6th April 1997. These regulations define **post 1997 service** as relating to the pension credit rights that are eligible for indexation if they are rights which are derived from the member's rights attributable under the scheme to pensionable service on or after 6th April 1997. This policy ensures that the PPF will mirror schemes.

7.48 The regulations under paragraph 28(7) of Schedule 7 to the Act also provide the Board with discretion to determine pre and post 1997 service in relation to pension credit members where there is uncertainty. This provides flexibility for the Board to make decisions where, for example, records may have been lost or destroyed.

Cash Balance Schemes: modification of paragraphs 5, 15 and 19 of Schedule 7

7.50 Cash-balance schemes are not money purchase schemes (a scheme where the return is dependant upon investments made and is therefore not a guaranteed sum on retirement) and so are eligible to enter the PPF. However, because these schemes are different to a standard defined benefit scheme (a scheme where the pension is defined by the scheme) modification of certain paragraphs of Schedule 7 of the Act are required to enable the PPF compensation to be paid to cash balance scheme members.

7.51 On retirement members of a cash balance scheme are entitled to a cash sum which is typically derived from a percentage of salary in each year of service often with a level of revaluation. This cash sum (subject to any allowance for a tax free lump sum) is then converted by the scheme trustees or managers to a pension by the securing of an annuity either with an insurance provider or within the plan, possibly on guaranteed terms.

7.52 Because Cash Balance schemes require the trustees or managers of the scheme to use the guaranteed lump sum to purchase a pension or annuity, there may be no detail within the scheme rules as to how the annual rate of the pension is actually calculated.

7.53 These regulations therefore provide for modification of paragraphs 5, 15 and 19 of Schedule 7 of the Pensions Act 2004 as these paragraphs require that compensation is calculated in accordance with the permitted scheme rules. These regulations provide the Board with the power to determine the initial annual rate of pension where it is unable to do so by reference to the permitted scheme rules.

7.54 These regulations ensure that the PPF will be able to pay compensation to cash balance scheme members in cases where the scheme rules are unclear as to how to calculate the initial annual rate of pension.

7.55 Consultation has not taken place for these regulations.

7.56 There is no need to refer to SSAC as the Pension Protection Fund is a Non-Departmental Public Body and does not provide Social Security Benefits.

8. Impact

8.1 A Regulatory Impact Assessment has not been prepared for this Instrument as it has no impact on business, charities or voluntary bodies.

8.2 There is no impact on the public sector.

9. Contact

9.1 Julie Lapraik at the Department for Work and Pensions tel: 0207 962 8472 or email: Julie.Lapraik@dwp.gsi.gov.uk can answer any queries regarding this instrument.