

**EXPLANATORY MEMORANDUM TO
THE OCCUPATIONAL PENSION SCHEMES (MODIFICATION OF
SCHEMES) REGULATIONS 2006**

2006 No. 759

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

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. **Description**

- 2.1 These Regulations:

- disapply section 67 of the Pensions Act 1995 in relation to certain modifications,
- set out the qualifications or experience required for a person providing an actuarial equivalence statement under section 67C of the Pensions Act 1995,
- describe requirements for the calculation of the actuarial value of a member's subsisting rights,
- provide pension schemes with the power to make certain changes to scheme rules by resolution,
- Revoke the Occupational Pension Schemes (Modification of Schemes) Regulations 1996.

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

- 3.1 Regulations 6 and 7 come into force on 30th March, which is less than 21 days after the regulations are laid.

- 3.2 These regulations give trustees of occupational pension schemes the power to make changes to scheme rules to reflect changes to the tax treatment of pensions introduced under the Finance Act 2004. These changes are effective from 6th April 2006, but the Department has been asked by the Association of Pension Lawyers to bring regulations 6 and 7 into force as early as possible.

3.3 The drafting of regulations 6 and 7 is consequential to the Registered Pension Schemes (Modification of the Rules of Existing Schemes) Regulations 2006 No 364 which were laid on 17th February, and could not be finalised before then. Because of the technical nature of the regulations, the Department felt that further consultation with the Association of Pension Lawyers was essential to ensure the regulations met the policy intention. This added a further two weeks into the planned timetable.

4. Legislative Background

4.1 Sections 67 to 67I were inserted into the Pensions Act 1995 by section 262 of the Pensions Act 2004 in place of the existing section 67, and come into force on 6th April 2006.

4.2 These regulations are needed to give full effect to sections 67 to 67I. They prescribe modifications where subsisting rights provisions do not apply, to set out qualifications or experience required of person making actuarial calculations, to prescribe more details about how actuarial values are to be calculated, and to provide pension scheme trustees with the power to modify scheme rules in certain circumstances.

5. Extent

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy Background

7.1 Section 67 of the Pensions Act 1995 protects pension benefits promised under scheme rules by prohibiting amendments to the scheme which would or might be detrimental to an individual's entitlement or accrued rights.

7.2 In its Green Paper 'Simplicity, Security and Choice: Working and Saving for Retirement' the Government recognised that section 67 has proved too restrictive and that schemes found it difficult to operate. It therefore sought views on an approach whereby schemes would be able to make very limited changes to a member's accrued rights without the consent of the affected member.

7.3 The Government subsequently introduced changes in the Pensions Act 2004 that would make it possible to make changes to members accrued pension rights where:

- there is a power in the scheme rules to make the change
- the trustees approve the change

- members are notified about the changes
- the affected member either consents to the change or the scheme complies with the actuarial equivalence requirement
- the actuarial equivalence requirement may not be used if the modification involves converting any Defined Benefit (Final Salary) pension rights into Defined Contribution (Money Purchase) rights

7.4 If the member does not consent to the change, the actuarial equivalence requirement requires that the actuarial value of the member's subsisting rights must be maintained. Actuarial value is maintained if the value, immediately after the modification is made, is equal to or greater than the actuarial value before the change is made. The method of calculating actuarial value under the new requirement is linked to the method for calculating Cash Equivalent Transfer Value (CETV) in these regulations.

7.5 A CETV is calculated according to GN11 – an actuarial guidance note produced by the Actuarial Profession that the actuary is required by regulations to use in calculating the cash equivalent of pension rights at any given point in time for the purpose of transferring rights between schemes.

7.6 We received 12 responses to consultation. Some respondents were concerned that changes to scheme rules required to comply with statutory requirements, or arising from tax simplification changes in the Finance Act 2004 should not be subject to the requirements of s67 and that schemes with insufficient amendment powers should be granted the necessary powers under section 68 of the Pensions Act. We have made provision for this in the final regulations.

7.7 There were a number of comments about the practical application of the CETV method of calculation for the purpose of section 67, but these are considered more appropriate for professional guidance.

8. Impact

8.1 An assessment of the impact on business, charities and the voluntary sector of the provisions in these Regulations was included in the Regulatory Impact Assessment that accompanied the Pensions Act 2004. The relevant extract is attached to this memorandum.

8.2 These Regulations impose no new costs on the public sector.

9. Contact

David Hone at the Department for Work and Pensions Tel: 020-7962-8684 or e-mail: david.hone@dwp.gsi.gov.uk can answer any queries regarding the instrument.

Extract from the Regulatory Impact Assessment accompanying the Pensions Bill 2004 (Lords)

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4.10 Simplifying the arrangements under which schemes are restricted from modifying accrued rights

4.10.1 Section 67 of the Pensions Act 1995 prevents changes being made to the rules of a scheme that would reduce a member's accrued pension rights without the member's consent. In effect it preserves not just the value of the member's rights, but the rights themselves.

4.10.2 It has been accepted that Section 67 is overly restrictive and that the requirement to obtain member consent prevents schemes from streamlining their administrative arrangements and adapting to changing circumstances. The objectives of the proposals being taken forward are to provide schemes with greater freedom to make modifications whilst providing an appropriate level of security and protection for scheme members.

4.10.3 The technical paper to the Green Paper proposed the introduction of a new 'de minimis' provision. This would permit limited changes to be made to a member's accrued rights without consent (up to 5% of the total value of a member's rights was suggested), provided the total actuarial value of the member's rights was maintained (any rights reduced or removed by the change being replaced by other rights of equivalent actuarial value).

4.10.4 Whilst there was some support for making no, or very limited, changes to section 67, the majority of respondents agreed that the legislation needed amending. Some of these agreed with the de minimis approach proposed in the technical paper (with a number suggesting the limit needed to be higher than the 5% proposed). The general response from the industry however, was that the de minimis approach would be far too complex to operate, and would not provide schemes with the necessary degree of freedom.

4.10.5 Alternative options suggested in the consultation responses fell into five broad categories:

1. Retain the current restriction, perhaps with minor changes to clarify the wording of the legislation, so that changes could only be made with member consent following consultation / negotiation.
2. Proceed with the de minimis approach, with a number of possible adjustments being suggested - such as a higher percentage limit, and clarifying the wording in the legislation.
3. Adopt the proposals made by Alan Pickering (schemes should be able to make changes without member consent provided: the trustees agree to any changes, and the actuarial value of each member's rights at the point of any change is maintained - the "equivalent value test").
4. Similar to the above option, but with a range of different additional provisions being suggested, including: requirement to consult with members about a proposed change, regulator to approve any change, prohibit specific types of change, permit changes that would within limits, reduce the value of a member's accrued rights.
5. Abolish section.67 and have no statutory restriction - relying instead on trust and employment law to provide protection to members' interests.

4.10.6 The Governments proposals for change are centred on option 4. It is not progressing with option 1 because any requirement that relies on consent would allow a minority of people to prevent change. Option 2, whilst considered a reasonable compromise by some, was felt by many to be far too difficult to administer whilst failing to provide schemes with any meaningful degree of flexibility.

4.10.7 Options 3 and 5 are not considered to provide sufficient security for scheme members. Under both these options, there would be nothing in legislation to prevent a scheme from converting a member's rights to a defined benefit (DB) pension into a defined contribution (DC) arrangement, without the consent of the affected member. Such a change would have a detrimental effect on the confidence of members of DB schemes and could destabilise these schemes.

4.10.8 The revised section 67 will allow schemes to make rule changes without member consent, provided:

- there is a power in the scheme rules to make the change;
- the change does not involve converting DB rights into DC rights;
- the trustees approve the change;
- the total actuarial value of each member's accrued rights at the point of any change is maintained, i.e. the actuarial value of any rights removed or reduced by the change are replaced by something of actuarial equivalent value;
- where a pension is already in payment, it is not reduced;

- members must be informed before a change is made and given the opportunity to make their views known.

4.10.9 The proposed approach strikes an appropriate balance between the desire of schemes to be free to adapt and reduce administrative costs and complexity, and the need to provide security for scheme members. Schemes will not need to obtain the consent of all the affected members in order to introduce a change. Members will be informed about any proposed change; the actuarial value of their accrued rights at the point of any change will be maintained and they will be protected from a fundamental DB to DC change or from any reduction in the prevailing rate of any pension already in payment.

4.10.10 These proposals are entirely permissive. They place no requirement or obligation on schemes to take any action. They will permit schemes to make changes to their rules in order to either reduce their future administrative costs and/or scheme complexity. Schemes may incur initial administrative costs to facilitate the change. The costs and savings associated with any changes will vary depending on the nature of the changes made and the particular circumstances of the scheme making them. In each case it will be for the scheme to decide whether the costs of introducing a specific change are proportionate to the reduction in complexity achieved and/or long term administrative savings.

4.10.11 Examples of the types of changes schemes might choose to make include changing:

- the date of the annual pension increase;
- the RPI reference month (which governs the annual pension increase award);
- the payment frequency (e.g. switching from 4 weekly to monthly);
- the date upon which pensionable salary is calculated;
- the definition of pensionable salary; and
- survivors' benefits.

4.10.12 The objective is to allow schemes the flexibility to make changes that could reduce administrative costs and complexity, whilst providing appropriate security for members. The proposals discussed here would meet that equity and fairness test.

4.10.13 The costs and benefits would apply to both small and large schemes/businesses. However, the provisions are more likely to be used by larger self-administered defined benefit schemes, which see the opportunity to reduce their administrative costs over time. Set against the total administrative costs of these larger schemes, the amounts involved are likely to be small. There may also be some additional costs for the Regulator if it needed to investigate a complaint that a scheme had failed to comply with the statutory procedures when making a modification. Additional work for the Regulator will be minimal.

4.10.14 The new Regulator, the Courts and to a limited extent the Pensions Ombudsman, will have a role in securing compliance with these proposals. The Regulator's role will be to investigate any complaint that schemes have failed to meet the 'procedural' requirements (members have been consulted, no DB to DC changes, the value of members accrued rights have been protected etc).

4.10.15 The Courts or possibly the Pensions Ombudsman will consider any complaints about the ability of schemes to modify their rules. Also whether trust law was properly applied when the trustees made their decision on whether to agree/consent to any changes.

Costs

4.10.16 Schemes that make any changes are likely to require a significant amount of actuarial work, as well as some modification to software on a more or less one-off basis. The aggregate cost is estimated to be around £10 million (one-off), on the assumption that around 50% of all defined benefit schemes make such changes, in steady state. In practice some schemes may make changes immediately, while others may only do so many years later. However, for presentational purposes it is assumed that steady state occurs in the first year, and as such this figure is very much a simplified presentation of the aggregate financial impact.

Administrative savings

4.10.17 It is estimated that those schemes that implement changes to simplify their administration (as discussed above) will make savings totalling around £3.5 million per year in aggregate, in steady state. This is based on staff time saved (including administrative as well as some professional staff) from not having to do large amounts of coding and checking, and not having to deal with queries from scheme members that would otherwise arise under the system of more complex scheme rules.