EXPLANATORY MEMORANDUM TO

THE PENSION PROTECTION FUND (COMPENSATION) (AMENDMENT) REGULATIONS 2018

2018 No. 95

1. Introduction

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

2. Purpose of the instrument

2.1 This instrument makes amendments to the Pension Protection Fund (Compensation) Regulations 2005[1] in relation to the compensation payable from the Pension Protection Fund (PPF) to those with 'step-down pensions'[2]. The amendments provide for the level of compensation in respect of a step-down pension to take account of future reductions which would have occurred in the rate of the pension under the rules of the original scheme.

3. Matters of special interest to Parliament

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

3.1 None.

Other matters of interest to the House of Commons

3.2 As this instrument is subject to negative resolution procedure and has not been prayed against, consideration as to whether there are other matters of interest to the House of Commons does not arise at this stage.

4. Legislative Context

4.1 The Pensions Act 2004[3] ("the 2004 Act") established the PPF and Schedule 7[4] to the 2004 Act sets out how the compensation payable by the Board of the PPF, when it assumes responsibility for a pension scheme, is determined. Generally, the rate of any periodic[5] compensation is based on the rate of pension a member was entitled to receive immediately before the day their scheme entered PPF assessment or, where the pension was not yet payable, what would have been the initial rate if the member had reached normal pension age. Thereafter, the compensation is usually payable at the same rate for life, subject to indexation where appropriate.

4.2 Paragraph 33 of Schedule 7 to the 2004 Act provides a power to modify the provisions of that Schedule as they apply to schemes of prescribed descriptions. Paragraph 15 of

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[1] http://www.legislation.gov.uk/uksi/2005/670/made

[2] A type of occupational defined benefit pension paid at an initial, higher amount which later reduces, usually at state pension age. The arrangement may also be known as high/low, bridging pension, integrated pension scheme, state pension offset or pension clawback

[3] http://www.legislation.gov.uk/ukpga/2004/35/contents

[4] http://www.legislation.gov.uk/ukpga/2004/35/schedule/7

[5] Refers to regular PPF compensation payments as opposed to, for example, lump sum payments

Schedule 8[6] to the Pensions Act 2008[7] amended paragraph 33 to provide specifically that the power can be used to alter the periodic compensation payable under "variable-rate" pension schemes. Variable-rate schemes are those under which the rate of pension payable to a person would have changed on a date after the scheme entered Pension Protection Fund (PPF) assessment, for example in the case of a step-down pension. The relevant provisions of the Pensions Act 2008 were commenced by the Pensions Act 2008 (Commencement No.16) Order 2018 with effect from 22 January 2018.

4.3 This instrument amends the Pension Protection Fund (Compensation) Regulations 2005 ("the Compensation Regulations") to modify Schedule 7 to the 2004 Act in its application to any scheme which enters an assessment period after this instrument comes into force, where under the scheme a member is receiving, or has accrued rights to, a step-down pension which is due to decrease on or after the assessment date. The amendments operate so that the PPF compensation payable in respect of step-down pensions reflects the reduction which would have taken place under the rules of the member's original scheme.

4.4 The instrument also makes consequential amendments in relation to the compensation cap, survivor benefits, early payment of compensation and postponement of compensation until after normal pension age.

5. Extent and Territorial Application

5.1 The extent of this instrument is Great Britain.

5.2 The territorial application of this instrument is Great Britain.

5.3 Northern Ireland will be making separate, parallel provisions.

6. European Convention on Human Rights

6.1 The Minister for Pensions and Financial Inclusion has made the following statement regarding Human Rights:

"In my view the provisions of the Pension Protection Fund (Compensation) (Amendment) Regulations 2018 are compatible with the Convention rights."

7. Policy background

What is being done and why

Changes in the Pension Protection Fund treatment of step-down pensions

7.1 The PPF provides compensation to members of defined benefit occupational pension schemes where the sponsoring employer becomes insolvent and the scheme assets are insufficient to provide all the scheme members with benefits at least equivalent to the amount of compensation that would be paid by the PPF.

7.2 As set out in paragraph 4.1, periodic compensation is generally based on the rate of pension payable immediately before PPF assessment starts, or what would have been the initial rate of the accrued pension. This has led to an anomaly in the PPF treatment of step-down pensions.

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[6] http://www.legislation.gov.uk/ukpga/2008/30/schedule/8
[7] http://www.legislation.gov.uk/ukpga/2008/30/contents

7.3 Currently members in receipt of the high rate of a step-down pension, or with accrued rights to such a pension, when their scheme enters PPF assessment receive PPF compensation based on the initial, high rate for life. However, if their pension scheme had not entered the Pension Protection Fund (PPF), the payments from their scheme would have reduced from a date specified in the scheme rules ("the decrease date"), usually the date on which they reach state pension age. This can result in such scheme members being financially better off in the PPF than they would have been had their scheme not entered the PPF. This instrument corrects this anomaly so that PPF compensation takes account of any step-down reduction which would have taken place under the rules of the original scheme.

7.4 The instrument identifies two distinct portions or elements of the member's step-down pension, and provides for them to be treated as two separate pensions for the purpose of the legislation which determines the PPF compensation payable to the member. The two elements of the step-down pension are the main portion, payable for the member's lifetime ("the basic element"), and an additional amount payable only until the decrease date ("the bridging element").

7.5 If the amounts of the two elements or the decrease date cannot be identified from the scheme rules, the instrument gives the Board of the PPF the discretion to treat those elements as such amounts, or the decrease date as such a date, as it considers appropriate.

7.6 These changes are being made so that those members with step-down pensions who happen to be in receipt of the high rate when their scheme enters PPF assessment, or have not yet started to receive their step-down pension, do not receive a potentially substantial windfall as a result of their scheme entering the PPF. The changes will help to ensure fairness of treatment in that members with benefits of equal value will receive similar levels of compensation.

The compensation cap

7.7 The PPF periodic compensation payable to anyone who is under their scheme's normal pension age at the start of PPF assessment (excluding those who have retired early on health grounds or are in receipt of a survivor's pension) is based on 90 per cent of their accrued pension. This amount is subject to an overall maximum, the compensation cap. The application of the cap is adjusted in individual cases to take account of factors such as the member's age on becoming entitled to PPF compensation, other periodic or lump sum compensation they are entitled to in relation to benefits under the same or a connected scheme, and any reduction in the rate of the pension as a result of the member having taken a tax free lump sum under their scheme.

7.8 The instrument provides the methodology to apply the cap to members with step-down pensions in order to take account of the reduction in the rate of compensation from the decrease date. It does this by providing that, in calculating the total value of the member's benefits to determine the amount of their capped compensation, the value of the bridging element is actuarially reduced so that it takes account of the value across a member's lifetime, rather than just the initial, high rate.

7.9 For example:
Two 60 year-old members of the same scheme are entitled to a pension of £35,000 for life but one opts for a step-down pension of £39,000 until reaching age 65 and £34,000 from then onwards. Neither has taken a pension commencement lump sum

and neither has any other benefit entitlements under the scheme. Assuming that the relevant PPF cap for a member aged 60 is £32,769.97 which then equates to £29,492.97 when the 90% restriction is applied, the member who has not opted for a step-down pension receives Pension Protection Fund (PPF) compensation at £29,492.97 for life (subject to indexation). The member who has opted to take a step-down pension is receiving a pension of £39,000 when the scheme enters PPF assessment and the PPF determines that, because £5,000 of that pension is only payable for five years, the actuarially reduced total value of their pension for the purposes of applying the cap is £35,000. This exceeds the cap and their compensation is £32,863.60 until they reach age 65, then £28,650.32 for the remainder of their life.

Early and late retirement

7.10 Members who opt to receive PPF compensation before their scheme's normal pension age (NPA) will have both the basic and the bridging elements of their compensation subject to an early retirement factor and reduced accordingly.

7.11 Members who choose to postpone receipt of their PPF compensation beyond their scheme's NPA but before their decrease date will receive compensation in respect of the bridging element, but no actuarial increase, from their retirement date to the decrease date, as well as actuarially increased compensation in respect of the basic element for life. However, members who choose to postpone receipt of their PPF compensation beyond their decrease date lose entitlement to the bridging element and their PPF compensation will only be in respect of the basic element.

7.12 Members are not permitted to take the bridging and basic elements of their compensation on different dates.

Survivors' benefits

7.13 The spouses and civil and relevant partners of members who die after the start of PPF assessment, but before the decrease date, inherit 50% of the deceased member's compensation in respect of the bridging element which is then paid up to the decrease date (or the survivor's own death, if sooner), as well as 50% of the compensation in respect of the basic element for life.

7.14 Where the member dies before reaching their scheme's normal pension age, the surviving spouse or civil or relevant partner inherits 50% of the deceased member's compensation in respect of the bridging element from the date of death and thereafter for the same length of time that the late member would have received it (or until the survivor's own death, if sooner). For example, where a married member dies aged 48 on 6 June 2018 and would have received compensation in respect of the bridging element for five years from age 60 to age 65, their surviving spouse receives 50% of the compensation in respect of the bridging element for five years from 6 June 2018 as well 50% of the basic element for the remainder of their lifetime.

7.15 Spouses and civil and relevant partners are the only categories of survivor of a member who can be entitled to any compensation in respect of the bridging element.

Consolidation

7.16 Informal consolidated text of instruments is available to the public free of charge via www.legislation.gov.uk.

8. Consultation outcome

8.1 There have been two formal public consultations regarding the regulations to correct the anomaly in the PPF treatment of step-down pensions. The first ran from 31 August to 1 October 2017 and consulted on draft regulations which would have actuarially converted the total pension, including the bridging element, into a flat-rate, lifetime-equivalent amount (the smoothing approach). The consultation also outlined an alternative approach of moving members to a lower rate of compensation after they reach the decrease date (the scheme rules based approach).

8.2 We received 28 responses to this consultation, mainly from the pensions industry and associated bodies. A significant proportion of the responses (15 out of the 23 who expressed an opinion) expressed a preference for the scheme rules based approach. This was mainly because the immediate drop in income for pensioners inherent in the smoothing approach could result in financial hardship, particularly where the bridging element was a high proportion of the overall pension.

8.3 Two consultation focus groups were also held, one with consumer groups and the other with pension scheme administrators and industry experts. The formal consultation responses reflect the strength of feeling in favour of the scheme rules based approach expressed during both focus group meetings.

8.4 In response, the Government ran a second consultation on draft regulations implementing the scheme rules based approach from 17 November to 3 December 2017. We received 10 responses, again mainly from the pensions industry and associated bodies. The responses were overwhelmingly in favour of the change in approach. One response pointed out unintended tax consequences in respect of the original policy in respect of late retirement and a minor change has subsequently been made to the draft regulations.

8.5 The Government's response to the public consultations has been published and can be found at: https://www.gov.uk/government/consultations/draft-pension-protection-fund-compensation-amendment-regulations-2018-technical-consultation.

9. Guidance

9.1 The Pension Protection Fund (PPF) will publish guidance regarding the revised treatment of step-down pensions on its website and amend its member notifications as appropriate.

10. Impact

10.1 There is no impact on business, charities or voluntary bodies.

10.2 There is no impact on the public sector, apart from on the PPF itself, which will be required to make whatever changes are necessary to implement the changes in the PPF compensation rules.

10.3 An Impact Assessment has not been prepared for this instrument.

11. Regulating small business

11.1 The legislation does not apply to activities that are undertaken by small businesses.

12. Monitoring & review

12.1 Suitable and proportionate arrangements for monitoring the changes will be agreed with the PPF.

13. Contact

13.1 Jill Metcalfe at the Department for Work and Pensions, telephone: 0113 232 4450, email: jill.metcalfe@dwp.gsi.gov.uk, can answer any queries regarding the instrument.