End of Contracting Out – Legal Perspective – is this the End of DB?

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Overview

- **Purpose**
  - Explain the impact that the abolition of DB contracting-out will have on DB plans that remain open to future accrual
  - Look at steps that sponsoring employers might take as a consequence
  - Does this mark the end of DB benefits for all?

- **Structure of the training**
  - Impact of the abolition of contracting-out on a defined benefit basis
  - Potential amendments to open DB plans
  - Practical considerations
INTRODUCTION
Reforming the state pension system

- The Government set out its plans for reforming the state pension system in 2013.
- The state second pension will be abolished and replaced with a single-tier state pension, the full rate of which will be set above the level of means-tested support.
- The single-tier state pension will be introduced from 6 April 2016.
- As a result, contracting-out on a defined benefit basis will also be abolished from 6 April 2016.
Impact of the abolition of contracting-out on a defined benefit basis
The abolition of contracting-out on a defined benefit basis will have cost implications for both employees and employers because of the loss of contracted-out National Insurance rebates.

From 6 April 2016:

- The Principal Employer will have to start paying the standard rate of National Insurance contributions, resulting in an increase in respect of each contracted-out employee of 3.4% of earnings between the Lower Earnings Limit (£112 pw for 2015/16) and the Upper Accrual Point (£770 pw since 2009/10).
- Employees who were contracted-out will see an increase in their National Insurance contributions equivalent to 1.4% of their earnings between the Lower Earnings Limit and the Upper Accrual Point. Employees will receive the higher single-tier state pension as a result of paying the additional National Insurance contributions.
Why might plan rules be changed?

- State pensions may be factored into the overall pension promise.
  - Definition of Pensionable Salary could have a LEL offset.
  - Bridging pension between NRD and State pension age (or 60/65).

- This makes more sense under the current two-tier State pension regime, but logically may not sit so easily with a (larger) single State pension.

- Amendments could also be made to offset the additional employer costs resulting from the loss of the National Insurance rebates.
Mechanics for making rule amendments
Two options

- Scheme amendment power
- Employer override
Scheme amendment power

- Set out in the Trust Deed and Rules.
- What is the balance of power?
  - Principal Employer power, but consent of Trustee needed (or vice versa)
  - Unilateral Trustee power
  - Actuarial certification
- Can changes be retrospective?
- Subject to section 67 of the Pensions Act 1995.
- Any special restrictions?
Employer override – what is it?

- Statutory modification power allowing employers to amend scheme benefits to the extent that they offset the cost of additional employer NICs payable.
- Employers will not need the consent of scheme trustees before using the modification power.
- Employers will need to obtain actuarial certification that any modification complies with the statutory requirements.
- The power only applies to future benefits and cannot be used in any way that would or might adversely affect members’ accrued rights.
- The power can only be exercised during the period of 5 years from 6 April 2016.
Employer override – what can it do?

- Employers can use the power to increase members’ contributions or alter members’ accrual rates, but cannot:
  - Increase employee contributions beyond the annual increase in the employer’s NICs in respect of them;
  - Reduce the amount of members’ benefits that accrue annually by more than the annual increase in the employer’s NICs in respect of those members; or
  - Use the power in any way that would result in the sum of any increase in contributions and reduction in benefits being more than the annual increase in the employer’s NICs in respect of them.
Employer override – calculation / verification (1)

- Before any proposed amendments are made, an actuary must certify that the amendment power is being used in a way permitted by the legislation.
- The actuary for this purpose must be appointed by the employer. The DWP’s March 2015 consultation response acknowledged that this could not in practice be the scheme actuary due to conflict of interests.
- The actuary must calculate the increase in the amount of employee contributions (if any), the increase in the employer's NICs and the reduction in scheme liabilities for the one-year period from the "calculation date".
The employer has some flexibility when selecting the calculation date, which can be any date after 31 December 2011, with the aim that employers will use the scheme's last triennial valuation as the base for their proposed amendments. The calculations must be based on earnings data for the one year period before the calculation date, unless these are "significantly abnormal".

Calculation should be made using the methods and assumptions used to calculate the scheme's technical provisions, but the actuary is allowed to adjust these to remove any prudence if that would be consistent with the principles that would be used to calculate a CETV.

If the calculation date is the same as the scheme valuation date, the methods and assumptions used for that valuation should be used, otherwise the methods and assumptions from the last valuation should be used but updated for market conditions.
Employer override - restrictions

- There is a prohibition on the employer making amendments which would remove a power to determine any matter from the trustees. For example, this would prevent changes to consent provisions for early retirement.

- The power cannot be used in relation to "protected persons" (that is, individuals who are former employees of nationalised industries who benefit from statutory protection of their accrued pension rights).

- The DWP consultation document states that "scheme contributions made via salary sacrifice is usually an arrangement between the employer and the employee and more likely to be a contractual agreement, which is why we have not provided for this type of arrangement in regulations". In other words, since scheme contributions made by salary sacrifice are contractual arrangements, the employer override does not apply to them as any changes would need explicit employee consent.
Employer override – consultation

- The statutory consultation requirements will be amended to remove the requirement to consult with affected employees when an employer simply terminates its scheme's contracting-out status.

- But consultation (at least 60 days) will still be needed if changes are made to scheme benefit design that fall within the current "listed changes", including changes made using the employer override.

- E.g. a change to the rate at which benefits accrue or an increase in employee contributions are both a “listed change”, so no decision to make such a change can be made unless the Principal Employer has consulted with affected members.
Employer override – information

- Trustees have a duty to provide to the employer "any information reasonably requested" by the employer "in connection with the use of the power" within a reasonable period (agreed with the employer) of any request.

- The type of information this covers is not specified but the DWP expects that it will include scheme data, such as the scheme’s benefit structure, as well as individual membership data.

- The DWP expects that the membership data needed would mostly be data which the employer would be likely to have already, but if not then trustees will not breach any data protection requirements by sharing this data.

- Civil penalties will apply when reasonable steps are not taken to meet the employer's request.
Double counting

- There are some concerns within the pensions industry that some employers may "double count" by making changes under their scheme's normal scheme amendment powers to take account of increased costs due to abolition, then seeking to make further changes using the statutory override.

- The DWP suggests that trustees should obtain the employer's written confirmation, when making any normal scheme amendments to recoup their increase in NI costs, to the effect that they will not subsequently use the statutory override power.
Practical considerations for trustees
Trustee’s requirements (1)

- If the Principal Employer intends to use the statutory amendment power, trustee consent is not required, but there are three key steps the Trustee should take:
  - Engage with the Principal Employer regarding what changes it wishes to make (currently the employer is considering its options);
  - Understand the Principal Employer’s proposal;
  - Check the Principal Employer is using the correct procedure in respect of the proposal; and
  - Implement the proposal, provided the two steps above have been satisfied.
Trustee’s requirements (2)

- Specific actions for the Trustee to take include:
  - Ensure the correct administration systems are in place in order to implement the proposal;
  - Communicate details of the change to members within three months of its effective date;
  - Consider other technical matters, such as the treatment of GMPs; and
  - Consider with the Principal Employer whether amendments are needed to the Schedule of Contributions.
GMPs

- Schemes will still need to comply with the existing GMP requirements.
- Further guidance will be provided in regulations not yet enacted.
- Any issues regarding the equalisation of GMPs will need to be addressed.
- GMP reconciliation is still needed by 2018.
IS THIS THE END OF DB FOR ALL?
The decline of DB benefits

- TPR Purple Book 2014
  - 13% of schemes in the data set are open to new members, 1% lower than 2013
  - 32% of schemes are closed to future accrual, 2% more than in 2013
  - Schemes with 10,000 or more memberships were most likely to be closed to new members but not closed to future accrual
  - There were 1.81 million active members in 2014

- LCP Accounting for Pensions Report 2015 shows that amongst FTSE 100 companies:
  - Only 3 have a DB scheme open to accrual and new members
  - 14 have no DB scheme at all
  - Of the remaining 86:
    - 50 have a DB scheme open to accrual (14 have already capped salary increases)
    - 13 have a DB scheme that provides non-final salary benefits
    - 23 have a DB scheme that is already closed to accrual
The decline of DB benefits

- ONS Occupational Pensions Survey 2014 (released September 2015)
  - Active membership of private sector occupational pension schemes by status and benefit structure, 2007 to 2014

*UK, millions*
Public sector

- 25 year settlement?
- Fair Deal
ANY QUESTIONS?
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