# First Actuarial Briefing for Trade Unions Q3 2018

## Introduction

Welcome to the latest edition of our briefing for trade unions. In this edition, we will also look at the following topics:

- Protecting Defined Benefit Pension Schemes – a White Paper
- Troubled waters for the Pension Protection Fund
- FABI surplus flourishes, as a PPF 7800 surplus could soon be a reality
- DC: Key Issues for Contributions
- Pension Fun Fact

## Protecting Defined Benefit Pension Schemes – a White Paper

There are currently over 10 million people in the UK who will rely on benefits from their defined benefit (DB) pension scheme.

With this in mind, Government have recently issued a White Paper, setting out how it intends to increase protections and make improvements to the current pensions system.

The three main themes to the proposals are to:

- Strengthen The Pensions Regulator's powers;
- Improve the funding system; and
- Encourage consolidation of pension schemes.

New powers for The Pensions Regulator (TPR) include fines for people who deliberately put their pension scheme at risk and making negligent behaviour in relation to a DB pension scheme a criminal offence. Whilst this sounds attractive in principle, we question whether this would be often used in practice.

On funding, Government believes that there is a significant minority of schemes where current good practice is not being followed. It has therefore proposed the following:

- A Code of Practice with a focus on deficit recovery plans and long-term objectives;
- Making compliance with the Code of Practice a statutory requirement; and
- Requiring all DB schemes to produce a Chair's Statement to TPR.

Our view on the proposed changes to scheme funding are as follows:

- Focussing on long-term objectives of purchasing insurance discourages employers from providing future accrual to new members, and creates a system where employers are required to plan to wind their schemes up.

- TPR's objectives are often not aligned with the objectives of trustees and employers, with TPR demanding ever higher funding targets, ever higher contributions and the reduction or elimination of future benefit accrual.

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- This places excessive costs on sponsoring employers, reducing their capacity to invest, provide employment and their ability to provide pensions to future generations.

If TPR is to be given more power over scheme funding, then we believe that TPR's statutory objectives should become more aligned with the objectives of trustees and employers. For example, one possible new objective for TPR could be to require it to work to raise the number of active members of open DB schemes.

Trade Unions should ensure that trustees of their own workplace schemes are well prepared for any changes arising from these proposals.

Government also intends to encourage innovation around scheme consolidation, with an aim to reduce sponsor costs and enable more effective investment strategies.

Whether this will be a success will remain to be seen. It's worth noting that The Pension SuperFund, the UK's first commercial consolidator of defined benefit pension schemes, has lost both its CEO and a main financial backer just six months after launching.

It is unclear exactly how consolidation would work for the majority of schemes at present. However, Trade Unions will undoubtedly want to be at the forefront in ensuring members' benefits are protected under any proposals to consolidate.

These changes are not expected to be effective before the 2019/20 parliamentary session.

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## Troubled waters for the Pension Protection Fund

The Pension Protection Fund (PPF), pays compensation to scheme members when the scheme's sponsoring employer has become insolvent. Two recent court cases have seen the PPF taken to court over the amount of compensation it pays.

These cases have centred on the reduction to benefits that members under normal retirement age (NRA) face on entering the PPF. When a scheme enters the PPF the following reductions apply:

- larger pensions are capped (at around £35,000 a year for a 65 year-old);
- pensions are then reduced by 10%; and
- pension earned before 6 April 1997 do not receive increases in payment.

*Mr Hampshire*

When Mr Hampshire's employer became insolvent, the impact of the PPF cap meant that he was only due to receive around 33% of his original pension from the PPF.

After the High Court rejected Mr Hampshire's appeal, he took his case to The Court of Justice of the European Union (CJEU), arguing that the compensation provided must be at least 50% of the original benefits.

On 6 September 2018, the CJEU agreed with Mr Hampshire and ruled that the PPF must pay out at least 50% of the value of the original entitlement.

Although the number of affected members is small, the PPF is having to reconsider its approach to compensation in these cases.

*Mr Beaton*

Mr Beaton had transferred benefits earned at a previous employer into the pension scheme of his current employer. When his current employer became insolvent, his pension scheme entered the PPF.

The PPF argued that when calculating Mr Beaton's PPF compensation, both periods of service should be taken into account when applying the cap on benefits, i.e. the service with his current employer *and* the service he had transferred in.

Mr Beaton argued that this was unfair and that the cap should be applied separately to his two pension benefits.

The High Court ruled in favour of Mr Beaton and has referred the case back to the Pensions Ombudsman to consider the implications.

Following this decision, the PPF originally consulted to "amend" regulations so that benefits relating to different pensionable service are aggregated before the cap is applied.

However, following the Hampshire judgement above, both Government and the PPF decided not to aggregate transferred in benefits, meaning that the Beaton judgement stands.

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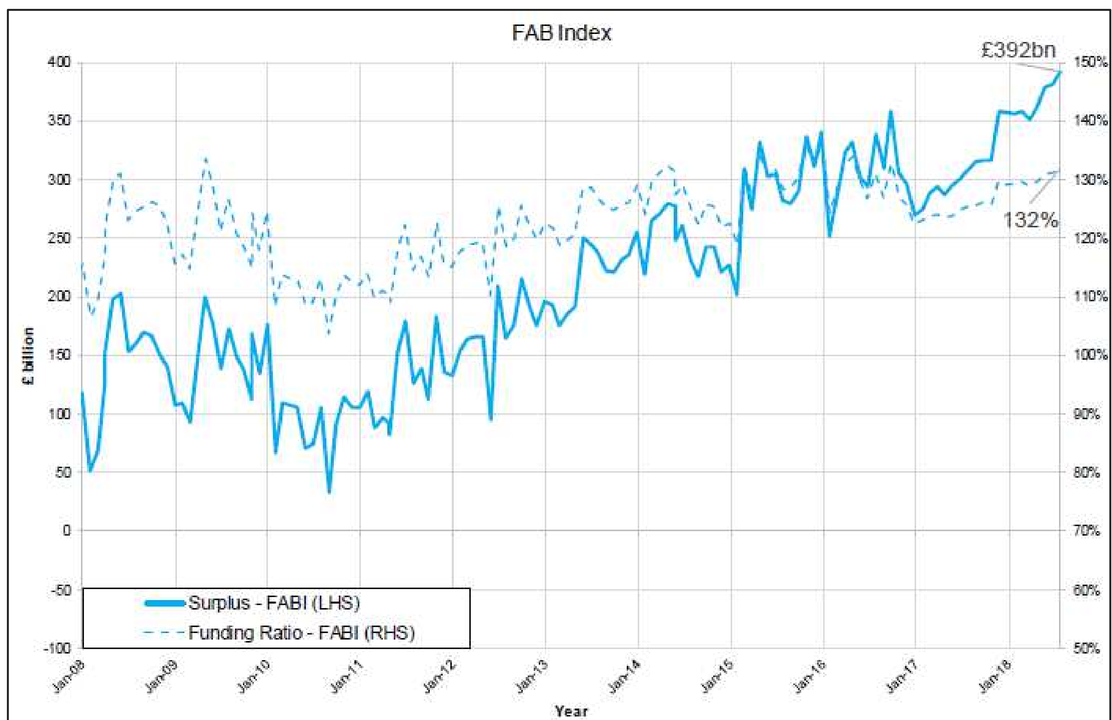
## FABI surplus flourishes, as a PPF 7800 surplus could soon be a reality

In our last briefing, we introduced the First Actuarial Best Estimate (FAB) index https://firstactuarial.co.uk/InfoCentre/FAB.

The FAB index shows the aggregate financial position of the UK's 6,000 DB pension schemes using the best estimate expected return on the assets held by those schemes.

At 31 July 2018, the FAB Index showed a record month-end surplus for July of £392bn, and a healthy 132% funding ratio.




The PPF has proposed to update the methodology it uses to value pension liabilities, bringing it more in line with how the latest data suggests insurance companies price annuities. Their proposal indicates that insurance companies are pricing annuities more cheaply than before due to 'extreme' competition - for example assuming pension scheme members are do not live as long, and assuming higher future investment returns.

The PPF is consulting on its proposed changes - with the changes due to take effect on or after 1 November 2018.

If it were it to update its methodology, the PPF has estimated that the PPF 7800 Index calculated at 30 June 2018 would improve from a funding ratio of 94.9% to 100.2%, moving 445 schemes from deficit to surplus, and producing a surplus overall. This is before the further improvements seen in their index over July are taken into account.

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## DC key issues for contributions

Following on from the previous briefings, we look below at the key issues on contributions to defined contribution (DC) schemes.

### *Auto-enrolment compliance*

All employers are now subject to the auto-enrolment legislation which requires enrolment into a pension scheme and the provision of a minimum level of contributions.

For DC schemes, minimum total and employer contributions are required. These started at very low levels and are being phased in by April 2019. The minimum contributions depend on the definition of pensionable earnings used, and are set out below.

| Pensionable Earnings | Definition | 6/4/2018 to 5/4/2019 | | 6/4/2019 onwards | |
|---|---|---|---|---|---|
| | | Employer | Total | Employer | Total |
| **Qualifying Earnings** | From £6,032 to £46,350 | 2% | **5%** | 3% | **8%** |
| **Set 1** | Basic pay | 3% | **6%** | 4% | **9%** |
| **Set 2** | Basic pay (provided this is at least 85% of total earnings) | 2% | **5%** | 3% | **8%** |
| **Set 3** | Total earnings | 2% | **5%** | 3% | **7%** |

### *Pensions Quality Mark*

Average employer contributions have been significantly reduced as a result of auto-enrolment. This is because many employers who previously didn't provide a pension at all now provide a minimum auto-enrolment level pension. The average employer was paying over 8% in 2012 but that average has been dragged down to less than 1% in 2017.

To counter the impact auto-enrolment is having on contribution levels, there is now a standard for DC pension schemes called the Pensions Quality Mark (PQM). This standard, measures the quality of governance, communications and contributions that schemes offer.

In terms of contributions, meeting the basic PQM standard is obtainable by a total contribution of at least 10% being available, with at least 6% from the employer. The PQM PLUS standard is obtainable with a total contribution of at least 15% of annual total pay being available, with at least 10% from the employer.

### *What should employers and employees contribute to DC?*

As a general rule of thumb, if total contributions of 16% per annum are paid into a DC arrangement over a 40-year period then the individual might expect to get around 50% of their salary as an annual income. This is double the longer-term contribution requirement under auto-enrolment legislation that is being phased in by April 2019.

Trade unions should negotiate with employers to increase contributions above the minimum compliance levels with a view to achieving better retirement incomes for employees.

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Employees should also be encouraged to review their contribution levels. With tax relief available on 100% of earnings (subject to the Annual Allowance), higher contributions are very tax efficient.

And of course, the other way to improve employees' pensions is by negotiating a pay rise!

Employees can also take advantage of salary exchange (also known as salary sacrifice) to save on National Insurance Contributions. For example, an employee earning £24,000 a year contributing 5% of their salary would see their take-home pay increase by £12 a month if they were to contribute using salary exchange.

### Pensions Fun Fact!

Answer to Q2 2018: **Turkey**

Question Q3 2018: What is the biggest recorded UK pension pot worth?
*[Answer in next quarter's bulletin]*

£5 million £7 million £21 million £22 million £34 million £41 million

## Further information

If you'd like more information on any of the issues contained in the bulletin, please contact:


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We welcome feedback on any of the issues covered and suggestions for issues that should be covered in the future. If any of your colleagues would like to receive future briefings but are not on our circulation list, please email alexandra.cherouvim@firstactuarial.co.uk and they will be added to the list.


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