Association of Consulting Actuaries

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Some legal points on the drafting of the Pension Schemes Bill 2014 as published on 26th June, 2014

Philip Bennett, Partner, Slaughter and May

Overview of this presentation

Part I: Structure of the Pension Schemes Bill 2014

Part II: Focus on the drafting of the new definitions in Part 1 of the Pension Schemes Bill 2014

Part III: A few words on schemes providing collective benefits

Part IV: Take-aways and questions

Part I

Structure of the Pension Schemes Bill 2014

Structure of the Pension Schemes Bill 2014

- Part 1: Categories of pension schemes (more later)
- Part 2: General changes to pensions legislation (in particular, changes in respect of revaluation of accrued benefits, exemption of regulatory own funds from indexation and other possible exemptions from indexation)
- Part 3: Collective benefits (more later)
- Part 4: Miscellaneous

Part II

Focus on the drafting of the new definitions in Part 1 of the Pension Schemes Bill 2014

What might a Member of Parliament think a defined benefit scheme or a defined contribution scheme is?

"There are currently two main types of private pension scheme:

- **Defined Benefit (DB) schemes**, that typically promise to pay a pension linked to salary and length of service, and
- **Defined Contribution (DC) schemes**, that typically pay out a sum based on the value of a member's fund on retirement."

Source: Improving outcomes for DC pensions: House of Commons Library Paper (SN6956), published on 7th August, 2014.

Paper says "this information is provided to Members of Parliament in support of their parliamentary duties".

So you thought you knew what a Defined Benefits Scheme was?

Think again!

"A pension scheme is a "**defined benefits scheme**" if –

(a) the scheme provides for all members to be paid **retirement income** beginning at **normal pension age** and continuing for life,

(b) there is a **full pensions promise** in relation to the **retirement income** and any other **retirement benefits** that may be provided to members, and

(c) the **normal pension age** in relation to the **retirement income** and any other **retirement benefits** that may be provided to members is **fixed**."

Source: Clause 2 of the Pension Schemes Bill 2014.

And I bet you thought you knew what a Defined Contributions Scheme was?

"A pension scheme is a **"defined contributions scheme"** if there is no **pensions promise** in relation to any of the **retirement benefits** that may be provided to the members"!!

Source: Clause 4 of the Pension Schemes Bill 2014.

Darwin's theory of definitional evolution and the missing link?

Defined Contributions Schemes

?

Defined Benefits Schemes

But did you know what a shared risk scheme is?

"A pension scheme is a **"shared risk scheme"** if –

(a) there is a **pensions promise** in relation to at least some of the **retirement benefits** that may be provided to each member, but

(b) the scheme is **not** a **defined benefits scheme**."

Source: Clause 3 of the Pension Schemes Bill 2014.

- **Important point:** A shared risk scheme is **not** a scheme which provides **collective benefits** (more later).
- **Question:** Is the Basic State Pension a shared risk scheme or a defined benefits scheme?

The wonderful world of pensions promises

- The full pensions promise
- Not the full pensions promise
- No pensions promise

Where did the term "pension promise" come from?

"Employees belonging to occupational pension schemes have certain reasonable expectations that the law should protect. These include the expectation that rights will accrue with service and, once accrued, will be protected and that benefits will be provided in accordance with the scheme rules and any legal requirements. **These reasonable expectations (which are not strictly legal rights, as trust deeds usually give wide powers of amendment to employers and trustees) form the core of what may be termed to be "pension promise".** It is this promise that the law should seek to protect, particularly in respect of accrued rights".

Report of the Pension Law Review Committee (1993) (Summary of Conclusions and Recommendations, paragraph 6)

Where is the term "promise" used in pensions legislation

- Until Section 21 of the Pensions Act 2011 was enacted, pensions legislation did not include the term "promise" within it.
- Section 21 deals with the meaning of **"cash balance benefit"**.

"I **promise** to pay the bearer on demand the sum of twenty pounds."

What is a promise in legal terms?

"The expression of an intention to do or forbear from some act.

In order to have legal effect and thus take effect as a contract, it must be:

- contained in a deed, in which case it is described as a covenant, or
- be in consideration of an act to be done (normally the payment of money) by the party to whom the promise is made".

Osborn's Concise Law Dictionary 12th Edition

The full pensions promise

"5 Meaning of “pensions promise” etc

(1) For the purposes of section 2 there is a **“full pensions promise”** in relation to a **retirement benefit** if –

(a) the scheme provides for there to be a **promise**, at all times **before the benefit comes into payment**, about the level of the benefit, and

(b) the **level** of the benefit is to be determined **wholly by reference to that promise in all circumstances**.

(2) For the purposes of sections 3 and 4 there is a **“pensions promise”** in relation to a **retirement benefit** if the scheme provides for there to be a promise, **at a time before the benefit comes into payment**, about the **level** of the benefit."

The pensions promise (cont'd)

"(3) A reference in this section to a **promise about the level of a retirement benefit** –

(a) includes a **promise about factors**, other than **longevity, that will be used to calculate the level of the benefit**,

(b) does **not** include a promise if, or to the extent that, it consists merely of a promise that the **level** of the benefit will be calculated **by reference to an amount available for its provision**, and

(c) in the case of a benefit the **level** of which depends on the amount available for the provision of benefits to or in respect of the member **and one or more other members collectively**, **does not include** a promise about the factors used to determine what proportion of that amount is available for the provision of the particular benefit."

The pensions promise (cont'd)

"(4) A scheme provides for there to be a **promise** if the scheme –

(a) sets out **the promise**, or

(b) requires **the promise** to be obtained from a third party.

(5) A scheme also provides for there to be a **promise** for the purposes of subsection (2) if the scheme provides for the member to be given –

(a) the option of a **promise** from the scheme, or

(b) **the option** of requiring a **promise** to be obtained from a **third party**,

(whether or not the option is subject to conditions)."

The pension promise (cont'd)

(6) A benefit does not fail the test in subsection (1)(b) **just because the scheme confers a discretion to vary the benefit** so long as the discretion –

(a) is capable of being used only for reasons related to a member's individual circumstances, or

(b) is of a description specified in regulations.

(7) When working out for the purposes of sections 2 to 4 what benefits **"may be provided"** to a member, take into account –

(a) benefits that may be provided only if the member has been a member for a certain length of time, and

(b) any other benefits that, at a future time, are benefits that may be provided to the member."

Source: Clause 5 of the Pension Schemes Bill 2014.

Definitions associated with the pensions promise

- The definition of **"level"**, in relation to a **retirement benefit**, means -

  (a) in the case or **retirement income**, the **rate** of that income, and

  (b) in the case of a **retirement lump sum**, the **amount** of that lump sum;

  Source: Clause 7 The Pension Schemes Bill 2014.

- The definition of **"retirement benefit"**, in relation to a member of a pension scheme, means –

  (a) **retirement income**, or

  (b) a **retirement lump sum**;

  Source: Clause 7 of The Pension Schemes Bill 2014.

Definitions associated with the pensions promise (cont'd)

- The definition of **"retirement income"**, in relation to a member of a pension scheme, means a pension or annuity payable to the member on reaching **normal pension age**.

  Source: Clause 7 of The Pension Schemes Bill 2014.

- The definition of **"retirement lump sum"**, in relation to a member of a pension scheme, means a lump sum payable to the member on reaching **normal pension age** or available for the provision of other retirment benefits for the member on or after reaching **normal pension age**.

  Source: Clause 7 of The Pensions Scheme Bill 2014.

What is the DWP trying to achieve?

- To create a space for new types of schemes (the shared risk scheme) where members can have some element of certainty on some part of their benefits.
- To achieve these policy objectives, it is seen as helpful to have the 3 new types of scheme definition.

Use of the new definitions

- To specify which schemes must have which governance structures.
- To specify what schemes must disclose what information.
- Possible relaxations (e.g. indexation of pensions in payment).
- But hands are tied on funding by Pension Funds Directive[1], Article 15.

1 2003/41/EC

Could this all be simpler?

See Article 48 of the proposed IORP Directive.

"Guarantees

(1) The pension benefit statement shall contain one of the following indications regarding **guarantees** under the pension scheme:

(a) a **full guarantee** where the institution or the sponsoring undertaking guarantees a given level of benefits;

(b) **no guarantee** where the member fully bears the risk;

(c) a **partial guarantee** in all other cases."

Note: The proposed Directive was published on 27th March, 2014.

Classification of schemes for funding purposes:

EXISTING REGIME (Part 3 of the Pensions Act 2004)

- **Money purchase** schemes
- **Other** occupational schemes

Reminder of definition of money purchase scheme

"**money purchase scheme**" means a pension scheme under which **all** the benefits that may be provided are **money purchase benefits**.

Note: No reference is made to the term **"pensions promise"**.

Source: Section 181 of the Pension Schemes Act 1993.

Reminder of definition of money purchase benefits (after Pensions Act 2011 changes came into force on 24th July, 2014)

"**money purchase benefits**", in relation to a member of a personal or occupational pension scheme or the widow, widower or surviving civil partner of a member of such a scheme, means **benefits the rate or amount of which is calculated by reference to a payment or payments made** by the member or by any other person in respect of the member **and which fall within Section 181B**;

Note: No reference is made to the term "**pensions promise**"

Money purchase benefits (Section 181B)

181B **Money purchase benefits: supplementary**

(1) This section applies for the purposes of the definition of **"money purchase benefits"** in **section 181(1)**.

(2) A benefit **other than a pension in payment** falls within this section if its rate or amount is calculated solely by reference to assets which (because of the nature of the calculation) must necessarily suffice for the purposes of its provision to or in respect of the member.

(3) A **benefit which is a pension in payment** falls within this section if –

(a) its provision to or in respect of the member is secured by an annuity contract or insurance policy made or taken out with an insurer, and

(b) at all times before coming into payment the pension was a benefit falling within this section by virtue of subsection (2).

Note: No reference is made to the term "**pensions promise**"

Source : Section 181B of the Pension Schemes Act 1993 – sub-sections (4) and (5) omitted – to save space

"Guaranteed Benefits" which can now be money purchase benefits

- a **4 x pay death in service lump sum**
- a **"return of contributions guarantee"**
- a **"guaranteed pension" at normal retirement date**

SO LONG AS THE SCHEME ONLY PROVIDES FOR WHAT IS RECEIVED FROM THE THIRD PARTY PRODUCT PROVIDER TO BE PASSED ON TO THE MEMBER/THE MEMBER'S SURVIVORS

Classifications of new definitions of schemes for funding purposes

Type of scheme	Classification for Funding purposes	Comment
1. Defined benefits scheme (new definition)	Part 3 of the Pensions Act 2004 applies, unless it is a money purchase scheme (in which case Part 3 does not apply!)	A rather counterintuitive conclusion
2. Shared risk scheme (new definition)	See 1 above	A rather counterintuitive conclusion
3. Defined contributions scheme (new definition)	Part 3 of the Pensions Act 2004 does not apply	Only provides money purchase benefits which have no pension promise

Part III

A few words on schemes providing collective benefits

Schemes which provide collective benefits

The drafting, at this stage, appears to be
in reasonably good shape

Part IV

Take-aways and Questions

Some points to take away

- **Remove** the references to **"promise"** in Part 1 of the Pension Schemes Bill 2014 and use more appropriate terminology (see definition of money purchase benefits)
- **Re-name** the terms **"defined benefits scheme"** and **"defined contributions scheme"** to avoid confusion with the existing terminology (when something different is meant)
- **More generally**, adopt a simpler and clearer approach to the definitions in Part 1 of the Pension Schemes Bill 2014

Questions

Any questions?