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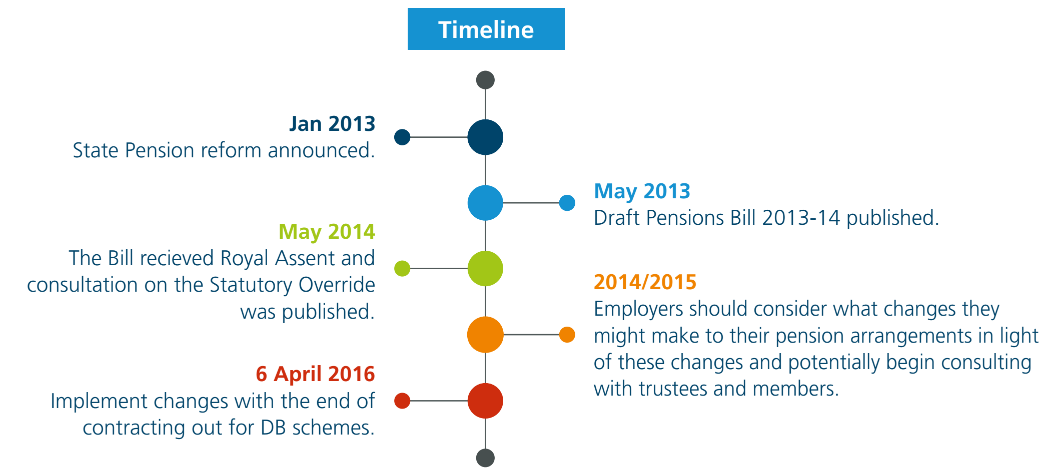
Briefing note

Single-Tier State Pension - Implications for defined benefit schemes

First announced at the start of 2013, the proposed reform of the UK state pension system has been accelerated by the Government and is now due to take effect from April 2016. Whilst the changes are intended to simplify state retirement benefits in the long run, the end of 'contracting-out' for open-to-accrual defined benefit (DB) arrangements will bring some short-term complications.

"The most eye-catching proposal is the introduction of a single-tier state pension from 2016 (worth £144 per week in today's money) to replace the current two-tiered system."

Scheme sponsors should start thinking about how the associated increase in National Insurance (NI) costs may be mitigated sooner rather than later as there may be factors which inhibit their ability to make certain changes.



Summary

The Pensions Bill 2013 sets out the fundamental reform of state retirement benefits in the UK. This includes an increase in the state pension age to 67, as well as a framework for further increases in the future. The most eye-catching proposal is the introduction of a single-tier state pension from 2016 (worth £144 per week in today's money) to replace the current two-tiered system. For employers that sponsor DB pension schemes still open to accrual, the discontinuance of the State Second Pension and the end of contacting out for such arrangements will mean both the employer and employee will pay a higher rate of NI contributions.

Contracting-out for DB schemes

Since 1978, DB pension schemes have been able to contract-out of the state second pension (formerly the State Earnings Related Pension). In doing so employees forfeited additional accrual of the state second pension with the intention that they would receive these benefits and more from their contracted-out DB scheme. The quid pro quo for employers and employees was that they paid a reduced rate of NI contributions under the arrangement.

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The impact for employers

The immediate impact of the State benefit changes for sponsoring employers is an increase in National Insurance Contributions (NIC) from April 2016. In the 2014/15 tax year, the NIC employer rebate was 3.4% (on earnings between £5,772 and £40,040). This equates to a significant additional cost for any employer intending to absorb the increase in NICs without any compensatory reduction to scheme benefits or an increase in member contribution rates.

The options for employers

For those employers wanting to mitigate the increase in costs, the two primary options are to offset the increase in NICs by reducing member benefits (for example, by reducing the accrual rate) or increasing member contributions or a combination of these two options.

How straight forward this is will depend on the trustee and employer powers in the scheme Trust Deed and Rules (Scheme Rules) as well as the existing trustee and employer relationship. If the employer does not have the unilateral power to change Scheme Rules or is unable to obtain trustee consent to do so, the employer may be able to make use of the statutory override power that the Government is consulting on. The statutory override will allow scheme rules to be amended without trustee approval.

Note that when considering increasing member contributions you should remember that members will already see a reduction in take home pay as a result of paying higher NICs themselves. In the 2014/15 tax year, a 1.4% reduction in NIC was given to contracted out employees (on earnings between £5,772 and £40,040).

An actuary appointed by the employer will need to certify that the reduction in member benefits or the increase in member contributions does not exceed the costs of the lost rebate. This cannot be the Scheme Actuary due to the potential conflict of interest. This will be tested on each benefit scale and for multi-employer schemes, for each employer rather than on an individual member level.

Statutory override

- The Government will make a provision available to private sector employers to allow them to amend future accrual of scheme benefits and/or employee contributions to offset the increase in costs associated with the loss of the NIC rebate.
- This will allow for scheme redesign without the requirement to receive consent from trustees.
- The costs recouped from any such exercise must not exceed the costs of the lost rebate.
- The powers will only be available for a limited time.

Employers will have a range of options for amending scheme contributions and benefits using the power. It is therefore necessary for consultation with members to take place, for the same reasons as for any other scheme amendments.

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Approximately 60,000 members of private sector DB pension schemes (or about 4% of the total membership of such schemes that are contracted-out) are subject to ‘protected persons’ regulations.

Reduction of benefits

- Where employers opt to recast scheme benefits, one of the simplest approaches will be to amend the future accrual rate. However, it will be difficult to find a simple adjustment to scheme benefits which will leave all active members in a broadly comparable position allowing for the extra state benefits they might receive and the higher NICs that will be paid.
- Employers will need to demonstrate that the value of scheme benefits foregone is no greater than the increase in NI costs that they are being asked to absorb. This will require actuarial certification by an employer appointed actuary (not the Scheme Actuary).
- All parties will be under considerable time pressure to push changes through via the statutory override in the run up to April 2016.
- Most employees should expect to receive a higher level of State Benefits as a result of these changes.

Increase rates of member contribution

- Affected scheme members (who will be simultaneously losing an NIC rebate of 1.4%) may be asked to absorb the increase in the employer’s NICs by paying higher contributions (and thus reducing the employer’s cost of ongoing benefit accrual).
- Employers could consider introducing a salary sacrifice arrangement to offset the extra NI costs.

Scheme closure

For an employer facing the unwelcome increase in costs unless they redesign future benefits or increase the member contribution rate, the end of contracting-out may prompt fresh consideration of closing the DB scheme to future accrual altogether. The Pensions Bill also includes an additional objective for The Pension Regulator to take into account the effects of DB funding ‘on the sustainable growth of the employer’. However, DB schemes remain a significant drain on an employer’s finances and the prospect of further benefit re-design may provide the impetus for sponsors to finally decide to close their DB schemes to accrual.

‘Protected Persons’ and contracting out

Approximately 60,000 members of private sector DB pension schemes (or about 4% of the total membership of such schemes that are contracted-out) are subject to ‘protected persons’ regulations. These apply in respect of the employees of certain formerly nationalised industries at the point when they were privatised. The regulations essentially mean that the employees’ benefit structures cannot be changed unless they choose to give up their protected status. The Government consulted on whether the statutory override should apply in respect of these employees, but have since announced that it will not apply. This means that employers looking to achieve a cost neutral position in respect of contracting-out may need to reduce salaries for these employees, rather than amend benefits or contribution rates.

This may cause trade union disputes and is also likely to result in different approaches being taken for protected persons versus other employees. The proportion of employees with protected status may be high in some industries and so care must be taken to develop a balanced approach.

> Employers will need to ensure that their 'contracted-in' scheme continues to function as a 'qualifying scheme' where they have decided to use it for the purposes of auto-enrolling employees.

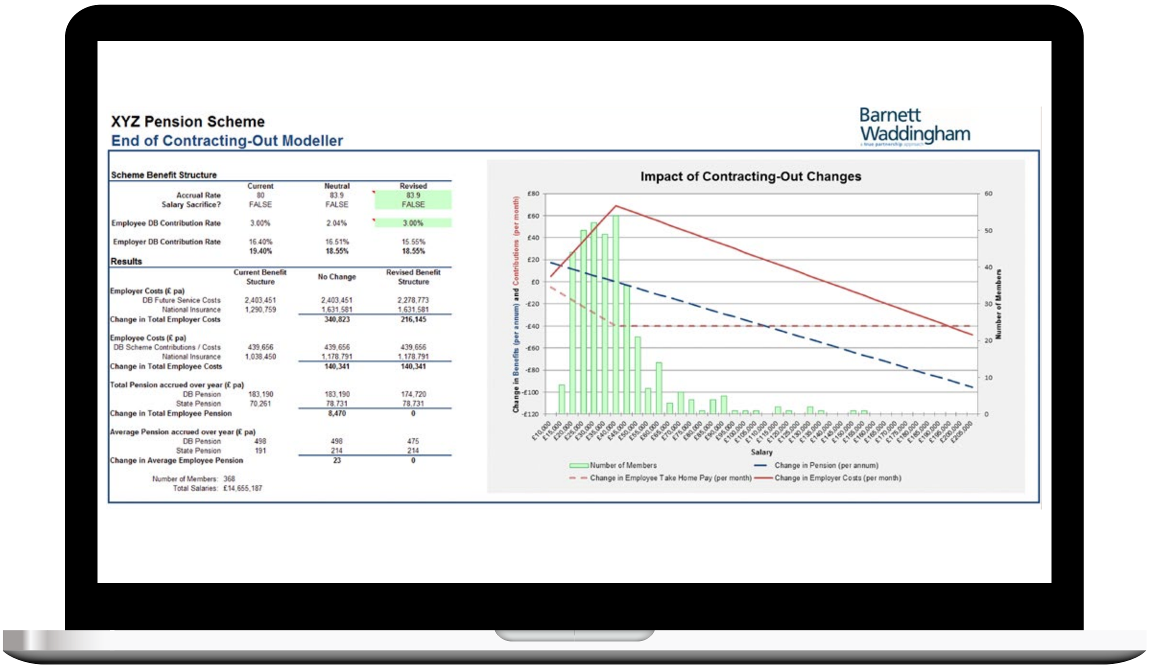
Other considerations for State Pension reform

There are a number of other consequences of these reforms which employers may have to consider:

- Some schemes may have explicit references to the state pension benefits in their rules, perhaps either to provide an equivalent bridging pension until State Pension Age or where an offset is used to calculate the benefit. If, for example, an amount equal to the 'Basic State Pension' is deducted from pensionable salary the scheme rules may need to be amended to avoid an unintended increase in the benefits provided by the scheme when the Basic State Pension no longer exists.
- When a scheme ceases to contract out it is now required to reconcile its records with those held by the National Insurance Contribution Office (NICO). The mass reconciliation of Guaranteed Minimum Pensions (GMPs) and other data is likely to lead to considerable logistical issues for NICO. This issue is likely to be compounded by GMP equalisation exercises undertaken once the Government clarifies the requirement to do so. The convenience of 'GMP conversion' (translating GMP benefits into normal scheme benefits) as a solution to this will be dependent on statutory guidance intending to simplify such exercises that the Government is currently working on.
- Employers will also need to ensure that their 'contracted-in' scheme continues to function as a 'qualifying scheme' where they have decided to use it for the purposes of auto-enrolling employees.

Impact modeller

We have built an interactive modeller to help you quantify the impact on your costs and consider how various benefit changes will alter your costs and the benefits provided to employees.



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Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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