ALLEN & OVERY



UK pensions: end of contracting-out

Issues for employers and trustees | April 2015

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Employers and trustees have had a busy period preparing for the April 2015 reforms to governance and access in relation to defined contribution pension arrangements but, for many, there's a new challenge on the horizon with the abolition of defined benefit (DB) contracting-out from April 2016.

A 12-month countdown has now begun; this guide sets out a timeline and key considerations for employers and trustees to April 2016 and beyond.

Overview

The new single-tier state pension will be introduced from 6 April 2016, meaning that the earnings-related element of the state pension will no longer accrue.

All DB arrangements will cease to have contracted-out status from this date.

The immediate impact, for employers currently sponsoring a contracted-out DB scheme, is an increase in payroll costs because the reduced rate of national insurance contributions (NICs) which applies to workers who are in contracted-out employment will be removed. The cost impact for employers in increased NICs, based on thresholds applying in the 2015/16 tax year, will be up to around GBP1,163 per worker. Members will also experience a reduction in take-home pay as the result of an increase in their own NICs.

Employers who prefer not to absorb this additional cost will be able to offset the increase in employer NICs from April 2016 either under the scheme amendment rule or by using a new statutory override power to reduce future accrual and/or increase member contribution rates. In either case, a consultation process with members will be required, which means that preparations need to start now if changes are to be effective from April 2016. Trustee involvement with any changes will vary depending on the mechanism used. Trustees will in any case have additional issues to consider in relation to reconciling their GMP liabilities with HMRC data.

¹ The override power does not apply to public service pension schemes, nor in relation to members with protected person status acquired on the privatisation of formerly nationalised industries.

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Action points

EMPLOYERS

- Assess the cost impact of the abolition of contracting-out.
- Decide whether any changes are to be made to member contribution rates and/or benefit accrual. Take actuarial advice on possible design changes (the overall saving from the changes may not exceed the increase in employer NIC costs following the abolition of DB contracting-out).
- Consider, with legal advice, whether any changes will be implemented using the scheme's amendment rule or the statutory override power. Follow the override procedure and/or liaise with the trustees accordingly.
- If changes are to be made, consider the timetable for implementation and plan an appropriate consultation exercise.
- Communicate with affected employees/members about the changes, including the impact of the increase in employee
 NICs on their take home pay, and what this will mean in terms of future state pension rights. The Government has published a series of leaflets to help with this.
- If you intend to continue to use the scheme to meet auto-enrolment requirements, consider the basis on which the scheme will be certified as from 6 April 2016.

Timelime for trustees and employers

If scheme is used to meet auto-enrolment duties, consider approach to certification from 6 April 2016

EMPLOYER

Consider possible approaches to offset.
Any changes, via rule amendment or override?
Appoint actuary. Liaise with trustees, obtain member data

Confirm proposed approach based on actuarial input

60-day consultation period should start before end Q4 Consider responses and confirm approach; obtain actuarial certification.
Consult trustees re amendment date

Earliest effective date of amendment

02 2015

Q3 2015

Q4 2015

01 2016

6 April 2016

TRUSTEES

Provide member data within agreed reasonable period Inform members of changes; amend rules to reflect changes implemented by override power

HMRC Scheme Reconciliation Service (SRS) available (deadline to register: 6 April 2016)

Obtain initial GMP data from SRS; consider approach to GMP reconciliation

Liaise with employer re approach to GMP reconciliation: cost, risk issues, etc.

Conduct/commission reconcilia

TRUSTEES

- Trustees of schemes which have not yet registered for HMRC's Scheme Reconciliation Service should do so as soon as possible.
- When data is received from HMRC, carry out a review to scope out the reconciliation work required and consider options for detailed reconciliation.
- Liaise with the scheme sponsor(s) to find out whether they intend to reduce benefit accrual and/or increase member contribution rates, either under the scheme amendment rule or the override power.
- Check the scheme rules to determine whether any references to state pension arrangements (particularly any state pension offset provisions) need to be updated.
- Once the regulations are finalised (due in summer 2015), check that all required protections for existing contractedout rights will be properly operated by the scheme administrators.
- Consider what member communications are required in relation to the abolition of contracting-out, and arrange for 'standing' communications such as the member booklet and scheme website to be updated in due course.

KEY

Blue text

Employer and trustee actions where the statutory override is used to make amendments to offset increased employer NI costs.

Red text and boxes

Actions in relation to GMP reconciliation

December 2018

HMRC: proposed end of scheme support services.
GMP data sent to members

HMRC support available to resolve queries based on SRS data

tion exercise; resolve any emerging issues

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The statutory override: what is it and how does it work?

The statutory override power allows employers to amend scheme rules without trustee approval in order to reduce scheme costs to reflect the increase in employer NIC costs. The options are to reduce future accrual or to increase member contributions (or a mix of both), in relation to some or all members of the scheme. It is subject to some restrictions:

changes may not impact on subsisting rights (so a change in accrual rate may only relate to future pensionable service)

the aggregate saving to the employer is limited to offsetting the increase in employer NICs only

money purchase benefits are not taken into account in the calculations the earliest effective date of any change is 6 April 2016, though the power itself can be exercised before that date

The override is available until 5 April 2021 (but can be used multiple times before then subject to the aggregate impact not exceeding the cap described above). In a multi-employer scheme, it is exercisable by the principal employer by or an employer nominated for this purpose.

Override power or scheme amendment rule - pros and cons

The choice of mechanism for any amendment – i.e. whether to use the scheme amendment power or the statutory override – will depend on the circumstances of each scheme and the overall result the sponsor wants to achieve. Employers are likely to need legal advice on this.

There may be situations where use of the scheme amendment power is required to cover something which cannot be achieved using the override (because of the limits on offsetting costs). An employer may therefore need to use the scheme amendment rule in relation to part of an overall package of changes.

Employers may need to get actuarial input and liaise with the trustees to gauge their response before deciding whether to use the statutory override or the scheme amendment power. In any event, trustees will be responsible for administering the revised benefit structure, so it

makes sense to check that their administrators will be able to implement the proposed changes. Trustees will also need to agree any changes to the employer's contribution rate if a new schedule of contributions is needed.

No particular formalities are required to make the change under the statutory override, which could give rise to problems when the rules are next consolidated. To avoid a situation where the precise impact on particular scheme rules has not been considered, or where the intended change is not translated accurately into subsequent rule amendments, we recommend that trustees should execute a deed reflecting the new position. This applies even where the effective change is made by the employer alone, to ensure that the rules reflect accurately the changes brought about by use of the override power.



Mechanics of using the override

In broad terms, the process is as follows:

Employer appoints an actuary

This cannot be the scheme actuary due to potential for conflicts of interest

Employer selects calculation date

This can be any date after
31 December 2011, providing flexibility
to fit in with valuation cycles

Actuary estimates future costs using method and assumptions applying for technical provisions as at calculation date

Employer may instruct actuary to adjust assumptions to exclude or restrict any margin for prudence (if retained, these could limit the amount of the increase the employer can recover)

Actuary certifies to trustees and employer that saving does not exceed employer NIC increase and that calculations have been made in line with the regulations

Calculations are based on a snapshot as at the calculation date projecting the value of the NIC rebate and the value of any scheme amendments over 12 months from that date

Employer consults trustees about, and then notifies them in writing as soon as reasonably practicable of, the effective date of amendments

Effective date of amendments may not be before 6 April 2016

Trustees: dealing with information requests

Employers will need to access scheme data and individual membership data to make the calculations, and trustees are required to provide relevant information in connection with the use of the override within a reasonable period, as agreed with the employer.

Where the calculation date is the same as a valuation date, and the valuation has been completed, the Government considers that relevant information should be obtainable within eight weeks.

Other issues for employers and trustees

Consultation

Wider employment issues

Schedule of contributions

Disclosure

'Doubledipping'

Any change involving a reduction in future accrual and/or an increase in member contributions would be a listed change requiring a minimum of 60 days' consultation with affected or prospective members of the scheme. This requirement applies whether the amendment is made under the scheme rules or using the override power. Where an employer decides to do nothing (i.e. to absorb the cost of increased NICs), there will be no requirement to consult about the cessation of contractedout status (though more general communications will be needed to inform members about the increase in their own NICs).

Some proposed changes might have an unequal impact across the scheme membership, either immediately or over time. The regulations do not prohibit cross-subsidy between groups of members, but the Government has stressed the importance of transparency between the employer and members in the consultation process, to promote fairness across all groups of members.

Employers should also consider wider employment law issues, for example any contractual terms or agreements with trade unions relating to pension benefits, such as an entitlement to noncontributory membership, or a particular accrual or contribution rate which would be affected by the proposed change. The override power does not extend to contractual commitments - so unless any such commitments are subject to the alteration power under the scheme rules or to changes in legislation, this would need separate consideration.

When considering what action to take in response to the abolition of contracting-out, employers should also consider members' reasonable expectations in relation to future service benefits before proposing a change and check any previous promises or assurances regarding the continuation of benefits before deciding on their preferred course of action. Employers should also maintain an audit trail to show that they have complied with the duty of good faith, including a business case for the proposed option and evidence of alternative options considered.

One important practical issue is that, where a change to contribution rates is implemented, this will not automatically feed through to the schedule of contributions. The override power does not allow employers to directly reduce their contributions to the scheme, and employers do not have a unilateral right to vary the debts they owe under the schedule of contributions: this would need to be revised separately, by agreement with the trustees. As a result, even where the override power is used. liaison with the trustees at an early stage of the process may help to avoid problems later. Employers have flexibility to select a calculation date which fits in with a valuation cycle, which could mitigate this issue in some cases.

Once an amendment affecting future accrual or member contributions has been decided upon, trustees will be required to provide information to members about the changes, either before or as soon as possible after (and in any event within three months of) the date the changes take effect. Member booklets, websites and other resources will also need to be updated.

Where the scheme amendment power is used to make changes to scheme rules to offset the employer's increased NI costs, this doesn't rule out later use of the statutory override. Trustees should take legal advice on how to take account of this in agreeing to any rule change.



What about existing contracted-out rights?

Protections for section 9(2B) rights and GMPs will be maintained, with some variations to reflect the abolition of DB contracting-out. However, HMRC's scheme support services in this area will eventually be withdrawn, as shown on our earlier timeline.

WHAT IS THE SCHEME RECONCILIATION SERVICE?

HMRC's Scheme Reconciliation Service (SRS) is designed to help administrators and trustees reconcile the membership and GMP data held on scheme records for all non-active members against HMRC records in advance of April 2016. Requests for reconciliation have to be made by April 2016. After that date, HMRC will continue to respond to membership and GMP queries in relation to the data provided under SRS until December 2018. For active members, HMRC will close its records in December 2016 and schemes will again have until December 2018 to agree or query membership data.

ARE TRUSTEES REQUIRED TO USE SRS?

There is no express legal requirement for schemes to use SRS, but trustees have a duty to pay the right benefits to the right members at the right time, and accurate records are a fundamental requirement in this context. The Pensions Regulator has for some time made clear that it regards good record-keeping as a fundamental part of good scheme governance, falling within the statutory duty to establish and operate adequate internal controls.

Trustees are also required, as data controllers, to ensure that scheme data is accurate and up to date.

From a scheme perspective, reconciling data via SRS is likely to be the easiest way to make sure that your GMP records are as accurate as possible, and can help you avoid additional risks (see box). As a result, it makes sense for trustees to take advantage of this time-limited opportunity to reconcile GMP data, and to do so early. Pressure on HMRC's resources in the two years to the end of 2018 may slow the process of resolving any queries. We recommend that trustees obtain SRS data, and carry out an initial review to scope out the reconciliation work required, as soon as possible. Detailed reconciliation of individual errors may in some cases be a complicated process, but your initial review should help you to assess the scale of work required.

We are providing legal input to the GMP working group established by the Pensions Administration Standards Association (PASA), which aims to produce industry standards and guidance for trustees and administrators on a pragmatic approach to GMP reconciliation.

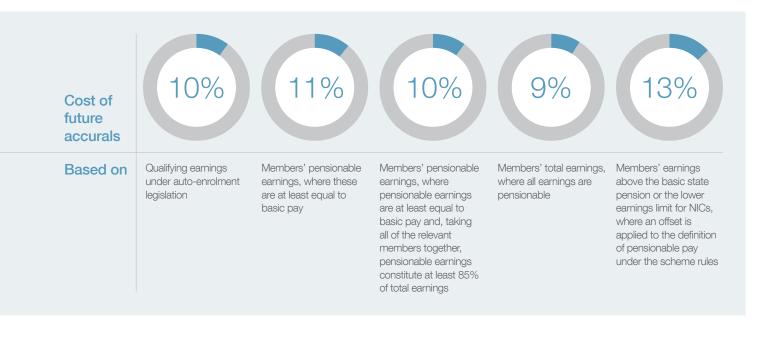
Risks of failing to reconcile GMP data via SRS

- Inaccuracies in scheme data (for example, service history information) could lead to over- or understatement of scheme liabilities, with implications for scheme funding decisions; and could result in incorrect benefits/increases being paid at a future date.
- A key problem area seems to be that, due to lost transfer/termination notices, HMRC data may record GMP liabilities in respect of members who have already transferred out either individually or as part of a historic bulk transfer. Early feedback from HMRC is that its records of scheme membership numbers may vary from those retained by the schemes themselves by up to 30%. In the event that no reconciliation is undertaken via SRS, we understand that HMRC's position is that the data held on its records should be deemed to be correct.
- If significant discrepancies like this are left unreconciled, it could lead to delay or higher premiums on a future buy-in, buyout or longevity swap exercise (because an insurer would effectively be taking on the risk of data inaccuracies). Similar issues may arise if/when GMP equalisation is required or the scheme is being wound up. At that stage, HMRC resources may not be available to resolve the problem.
- HMRC plans to send out individual member statements in December 2018. If the information HMRC provides to members on their GMP rights is inconsistent with the information they get from the scheme, problems could arise at a stage when HMRC's scheme support services in this area have been withdrawn.

Ongoing accrual and auto-enrolment

Currently, contracted-out DB schemes automatically meet the quality standards to be qualifying schemes for auto-enrolment purposes. Once DB contracting-out is abolished, all DB schemes will have to demonstrate that they meet the test scheme standard in order to maintain their qualifying scheme status.

To simplify the certification process, the Government has introduced alternative tests from 1 April 2015 based on the cost to the scheme of the future accrual of active members' benefits. These alternative tests run parallel to existing scheme funding requirements so that employers should not be required to undertake additional actuarial work in order to certify their scheme. The tests are as follows:



Calculations are based on the methods and assumptions used for scheme funding purposes, taking into account all benefits, with a reduction of 1% to the minimum level of contributions for schemes that do not provide dependants' pension benefits. The tests apply at the level of benefit scales rather than at the scheme level, so the cost of providing benefits to active members with different accrual rates would be tested separately. In the case of multi-employer schemes, participating employers can apply the test in respect of their workers separately if they wish to do so.

The Government has said that it will consider enabling the cost of accruals test to be satisfied on a scheme-wide average rather than at the level of benefit scales, for schemes that satisfy the Reference Scheme Test on 5 April 2016 – further details will be provided alongside other contracting-out-related changes in summer 2015.

What's happening to the state pension?

Currently, the state pension is made up of two main elements: the flat-rate basic state pension, plus an additional element known as the State Earnings Related Pension Scheme (SERPS) and, more recently, the State Second Pension or S2P. In addition, a means-tested pension credit guarantee is available to top income up to a minimum level (GBP151.20 for a single person in 2015/16).

Individuals reaching state pension age on or after 6 April 2016 will receive a new single-tier state pension, which replaces these three elements. The amount of the single-tier pension has not yet been finally confirmed, but explanatory documents issued by the Government use GBP148.40 as an illustrative amount. Anyone with 35 qualifying years of NICs will receive the full amount; a minimum of 10 qualifying years is required to be eligible for the state pension.

Transitional arrangements will apply to individuals with qualifying years attributable to the period up to 6 April 2016. A 'starting amount' will be calculated based on NI records as at 5 April 2016 and will be the higher of:

- the amount of state pension the individual would get on the current basis; or
- the amount the individual would get if the new state pension had applied throughout his/her working life.

Individuals who have had periods of contracted-out employment will receive a 'contracted out deduction' to account for the fact that they have benefited from NIC rebates during these periods (and that, as members of a contracted-out arrangement, they should receive a pension from that arrangement which is at least broadly equivalent to the additional state pension they would have received if they had not been contracted out).

If the starting amount is less than the full single-tier state pension, then each qualifying year after 5 April 2016 will increase the starting amount, up to the full level of the single-tier state pension or the date when the individual reaches state pension age, whichever happens first. Some people may have a starting amount which is more than the full rate single-tier state pension, in which case the additional amount will be protected.



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