Commentary on...

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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. The end of 'contracting out' for open-to-accrual defined benefit (DB) arrangements will bring some short term complications to those that sponsor them. Employers will therefore need to act quickly to mitigate the associated increase in National Insurance (NI) costs.

Timeline

January 2013

State Pension reform announced.

May 2013

Draft Pensions Bill 2013-14 published.

Early 2014

The Bill will receive Royal Assent and details of the Statutory Override will be announced.

2014/2015

Employers should consider what changes they might make to their pension arrangements in light of these changes and begin consulting with trustees and members.

6 April 2016

Implement changes with the end of contracting out for DB schemes.

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.

Analysis by the Office for National Statistics (reported within its 2012 Occupational Pension Schemes Survey), showed that 75% of open DB schemes with at least 1,000 members are contracted out.

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 2013/14 tax year, the NIC employer rebate was 3.4% (on earnings between £5,668 and £41,450). 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.

With the latter option you should remember that members will already see a reduction in take home pay as a result of paying higher NICs themselves. In the 2013/14 tax year, a 1.4% reduction in NIC was given to contracted out employees (on earnings between £5,668 and £41,450).

The government has attempted to allay employers concerns that they will be prevented from taking appropriate remedial steps by a mixture of their scheme's rules and legislation by introducing a 'statutory override' which will allow scheme rules to be amended without trustee approval. It has been confirmed that the override may be used more than once; however, any costs recouped in this manner will be limited to the liability of the NIC rebate. It will be important for scheme sponsors to assess the level of impending extra costs as soon as possible and to begin considering how best the override may be used. More details will be provided in secondary legislation which we hope will be published soon after the Pensions Bill.

Statutory override

- The government will make a provision available to private sector employers to allow them to amend future accrual of scheme benefits 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 although it is not yet clear how this will be applied.
- 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.
- Depending on the exact circumstances of each scheme, the process is likely to time consuming. An example of where it may be particularly challenging will be for multi-employer schemes.
- The government intends to publish further details of the override 'as soon as possible' though the timetable for employers, trustees, and advisors to act will be undoubtedly tight.

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.
- All parties will be under considerable time pressure to push changes through via the statutory override in the run up to April 2016.
- Employee consultation will be necessary for any more fundamental redesign of future benefits (though there will be no requirement to consult on the end of contracting out itself).
- 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).
- Employee consultation will be necessary and time constraints will be considerable as above.
- 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.

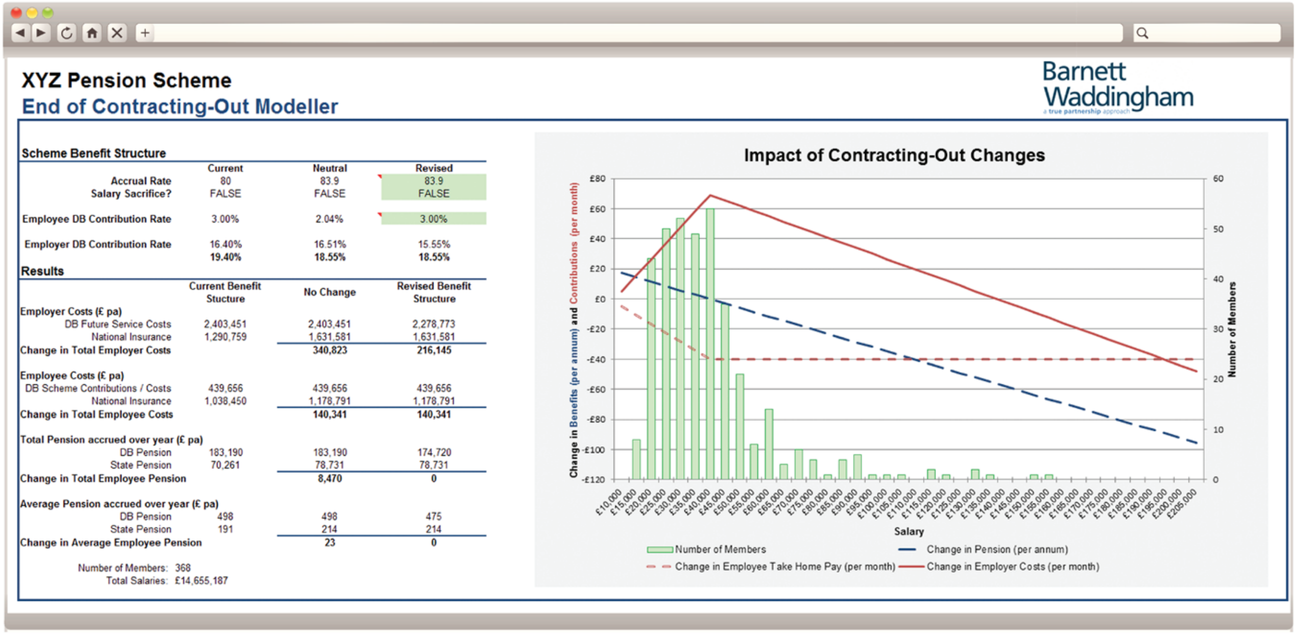
Other considerations for State Pension reform

There 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 (GMP) 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 (expected in 2014). 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 in the 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.



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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