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Pensions Act 2014: all you need to know

The Pensions Act 2014 (the Act) has been somewhat overshadowed by this year's attention-grabbing, Budget. However, it is a key piece of legislation. Not only does it introduce a new type of state pension and, as a consequence, sweep away contracting-out on a defined benefit (DB) basis, but it also contains several important measures for occupational pension schemes.

State pension reform

The current state pension system comprises the basic state pension, the additional state pension (ASP) (now known as the State Second Pension or 'S2P', but formerly the State Earnings Related Pension or 'SERPS') which is linked to earnings, and the pension credit (a means-tested benefit).

For people who reach state pension age (SPA) prior to 6 April 2016, nothing will change. The Act will only create a new state pension for those reaching SPA on or after that date.

On and from 6 April 2016, a person with 35 or more qualifying years of national insurance contributions (NICs) will be entitled to the full state pension. This was estimated to be £144 per week in 2012-13 prices, but the actual amount will be specified in regulations nearer to the date of implementation.

Transitional arrangements will be introduced for those with qualifying years attributable to the period up to 6 April 2016. These aim to ensure that anyone who, at the date of change, would have been entitled to a higher payment than the new flat rate pension will not lose out.

Abolition of DB contracting-out

Since the 1960s sponsoring employers of DB occupational pension schemes have been allowed to contract their employees out of the ASP, on the condition that they would provide an occupational pension meeting certain statutory requirements (which have changed over the years). The aim of these requirements is to ensure that the employees will become eligible to receive a pension in their contracted-out scheme which is broadly equivalent to the ASP to which they would otherwise have become entitled.

In return for the employer providing a pension which meets the statutory minimum, both the employer and the employee pay reduced NICs. The current reduction, known as the contracted-out rebate, is 3.4% for employers and 1.4% for employees.

When the single-tier state pension is introduced, ASP will cease to exist. As a result, DB contracting-out will be abolished from the same date.

When contracting-out on a defined contribution (DC) basis was abolished in April 2012, generally protected rights simply

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converted into normal DC benefits. In contrast, on the abolition of DB contracting-out, past service contracted-out rights (guaranteed minimum pensions and section 9(2B) rights) will be retained within schemes, and will remain subject to similar statutory requirements.

Statutory modification power

When contracting-out is abolished, employers will start to pay NICs at the full rate (currently 13.8%) on employees' earnings. This additional cost will be a huge blow for those employers sponsoring open DB schemes. Recognising this, the Government has decided to provide employers with a unilateral power to amend their schemes, in relation to some or all of the members (including future members), to take account of the increase in the employer's NICs.

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The power may be used to increase the contributions of relevant members and/or alter their future benefit accrual, but it is subject to several conditions. Broadly, it must not create a saving for the employer of more than its annual increase in NICs, and it must not be used in a way that might adversely affect the "subsisting rights" (accrued pension rights or entitlements) of a scheme member or a scheme member's survivor.

Before any amendments can be made, an actuary will be required to certify that the proposed changes meet the relevant requirements, and that he or she has carried out their calculations in accordance with the relevant regulations. The regulations which set out the detail of these calculations and other procedural aspects of the modification power were part of a recent Department for Work and Pensions (DWP) consultation.

The power may be used more than once, but is currently only intended to be available for a limited period of five years. However, the Act reserves the power to extend this period.

SPA

Under plans originally put forward by the Labour government, SPA was due to increase to age 67 between 6 April 2034 and 5 April 2036.

Responding to faster than projected increases in life expectancy, and the need to keep the state pension system affordable, the Act provides for this timetable to be accelerated. The increase will therefore now occur between 6 April 2026 and 5 March 2028.

In addition, the Act makes provision for SPA to be periodically reviewed by the Secretary of State, in light of changes to life expectancy and other relevant factors. The Secretary of State will be required to prepare and publish a report in relation to the review.

The first of these reports must be issued before 7 May 2017, with subsequent reports due every six years. Any change to SPA would be introduced by primary legislation.

Automatic transfers

The Act contains a duty for the Secretary of State to make regulations to establish a system of automatic transfers of pension benefits (also known as "pot follows member") and sets out a framework for the new system.

If certain requirements are met, an individual's accrued rights under a DC (or other prescribed) scheme will be eligible for transfer to their current pension scheme. These requirements include that the individual's pension pot is of a certain size and was accrued after a certain date.

It will be possible for the individual to stop a transfer occurring. The regulations may either require the member to consent to the transfer or make it possible for them to opt-out.

The Government has indicated that, initially, only pots of up to £10,000 may be transferred. However, the Secretary of State will need to review this limit at least every five years, and revise it if appropriate.

The rationale underpinning this system is the need to address the expected increase in the number of dormant, often small, pots following the introduction of automatic enrolment. Having considered other options, such as an aggregator scheme, the Government concluded that automatic transfers would benefit members and providers. The theory is that members will be able to build up one substantive pension account, which may ease conversion to an annuity, while providers will benefit from having to administer fewer dormant pots. The policy also aimed to help people monitor their pension benefits and increase engagement with their savings.

It is arguable that the need for a mechanism to consolidate DC pension pots in order to ease conversion to an annuity has been decreased by measures announced in the Budget 2014. Subject to specific conditions being met, since March 2014:

- the amount which can be taken as a lump sum under the general rules on "trivial commutation" has increased from £18,000 to £30,000; and
- small pots of up to £10,000 can be paid out as cash

This makes it easier for both individuals and schemes to deal with small pension pots when a member reaches age 60. Further, if the Budget proposals are implemented, from April 2015 individuals will be able to take their entire DC pot(s) as cash, subject to tax. While an annuity is still an option and will remain attractive for some, it will no longer be essential for those who do not want to use income drawdown.

However, there is still an argument for easing the administrative burden and for helping individuals to keep track of their pension benefits, and we understand that Steve Webb, the Pensions Minister, remains wedded to this new system. While an implementation date has yet to be confirmed, we understand that automatic transfers are likely to be introduced in 2015.

Abolition of refunds of contributions for DC schemes

The abolition of short-service refunds for DC members sits alongside the proposed system of automatic transfers.

The Government intends pension saving to be the norm, and that pension contributions should remain in schemes to be invested to produce retirement income for members. Refunds of contributions run counter to this intention, and are relatively popular. In 2009, DC schemes made 20,000 such refunds, and the Government expects this figure to rise to 100,000 per annum as automatic enrolment becomes more widespread.

The Act therefore provides for DC benefits to vest as soon as a member has completed 30 days' qualifying membership of a scheme. The intended effect of this is that short-service refunds will no longer be available to members who give up their membership within two years but after 30 days.

However, this section will only apply to individuals who first become active members of a scheme, or who re-join a scheme having already taken a refund or transfer, on or after the date it comes into force. This date has not yet been specified, but Steve Webb has indicated that it will be in 2014.

Charges cap, disclosure and governance/ administration requirements

The Act provides for regulations to be made to prohibit "administration charges" from being imposed on members of certain schemes, and to impose administration and governance requirements. The Pensions Regulator may be given powers to ensure that schemes comply.

The Government and the Financial Conduct Authority will also be required to legislate or make general rules, respectively, requiring information about some or all of the transaction costs and administration charges of an occupational DC scheme, and certain personal pension schemes, to be both published and given to members and prospective members, spouses or civil partners.

The regulations may also require the publication of additional information which would or may assist in making comparisons between schemes' costs and charges.

The detail of the Government's proposals was contained in its recent Command Paper: "Better workplace pensions: further measures for savers". Key points include:

- minimum governance requirements will apply from April 2015 for all DC workplace pension schemes
- occupational pension scheme trustees will need to provide an independently audited statement that they have met the new governance standards
- contract-based schemes will need to establish Independent Governance Committees (IGCs) to perform a similar role to trustees, to improve accountability and assess value for money. They will also have an obligation to report on how they have met the new governance standards
- from April 2015, there will be a charge cap on default funds of 0.75%, and a ban on commission or consultancy charges in DC schemes which can be used for automatic enrolment (known as qualifying schemes). It is estimated that the charge cap will result in additional savings for individuals of £195 million over the next ten years
- from April 2016, all active member discount structures and member-borne commission payments will be banned in qualifying schemes
- from April 2015, there will be mandatory disclosure of costs and charges in a standard format, and a duty on trustees and IGCs to consider and report on these

All of the above are aimed at ensuring that individuals, particularly those who are automatically enrolled, receive value for money from their DC pension schemes, and that any member-borne charges are fair and appropriate. A recent Office of Fair Trading DC market study found that competition alone was not sufficient to achieve this, due to the weakness in the buyer side of the market and the complexity of the product. Further, the lack of transparency of pension scheme charges means that both individuals and employers are unable to assess and compare schemes.

> The Government intends pension saving to be the norm, and that pension contributions should remain in schemes to be invested to produce retirement income for members

Technical changes to automatic enrolment

The Act makes several technical changes to the automatic enrolment legislation.

Exceptions where automatic enrolment is deferred

On and from their "staging date", employers must automatically enrol workers who satisfy certain age and earnings criteria ("jobholders") into a qualifying workplace pension scheme. But, employers may postpone automatic enrolment for up to three months, known as the "waiting period".

Employers who will be using a DB or hybrid scheme may, subject to certain conditions, defer automatic enrolment until the end of a transitional period (30 September 2017). Such employers may then make use of the waiting period to postpone automatic enrolment for a further three months.

Employers also have a duty every three years to re-enrol any jobholder who opted-out or left the scheme.

Under the current legislation, it is possible for the duty to re-enrol to fall within the transitional or waiting periods. The Act will therefore remove this duty if automatic enrolment has been legitimately deferred.

Power to create general exceptions

Employers' automatic enrolment duty is subject to certain limited exceptions. But there is currently no general power to exclude certain types of workers, or workers in certain circumstances.

The Government is reluctant to introduce a specific exclusion, as it considers this might carry an increased employer monitoring burden. However, it recognises that automatic enrolment and pension saving will not always be appropriate. In addition, automatic enrolment can, in some circumstances, impose unnecessary work on the employer, and cause an individual to incur a financial penalty.

Categories of worker who it may be appropriate to exclude from automatic enrolment include:

- individuals with enhanced or fixed tax protection
- active members of DC schemes who have given notice of retirement, and
- people who hand in their notice during a deferral period

Rather than create a specific exclusion, the Act introduces a power for regulations to be laid which create exceptions to the general duty to automatically enrol. In respect of certain types of worker, or in particular circumstances, these regulations may allow an employer to choose whether to automatically enrol an individual. They may also provide for the duty to automatically enrol to be reinstated if the circumstances which triggered the exclusion change. However, the provision prevents the introduction of any exceptions based on the size of the employer.

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Alternative quality requirements for DB schemes

Currently:

- contracted-out DB schemes automatically qualify for use in automatic enrolment, and
- contracted-in schemes qualify by meeting the "test scheme standard" in relation to all jobholders.

The test scheme is a hypothetical scheme used as a benchmark against which a scheme can be measured. To meet the test scheme standard the scheme must provide benefits to members which are broadly equivalent to, or better than, those which would be provided under the test scheme.
With the abolition of DB contracting-out looming, the Act provides a power for regulations to be laid which will allow DB schemes to satisfy the quality requirements if:

- the money purchase quality requirement (the scheme provides a total contribution of 8% of qualifying earnings [broadly, jobholders' gross earnings in a year between £5,772 and £41,865] with at least 3% contributed by the employer) is met; or
- the cost of funding future accruals for "relevant members" over a "relevant period" would require total contributions of at least 8% of the members' total "relevant earnings"; or
- in the case of at least 90% of the "relevant members", the cost of providing future accruals over a "relevant period" would require total contributions of at least 8% of a member's total "relevant earnings" over that period.

All the phrases in quotation marks will be defined in the regulations.

These regulations must be reviewed on an ongoing basis to check that the Government's policy intentions are being achieved. The first review will be in 2017, with subsequent reviews following at least every three years.

Transitional period for hybrid schemes

Different transitional arrangements apply in respect of automatic enrolment, depending on whether a DC, or a DB or hybrid pension scheme is offered by the employer.

Where a DC scheme is used, employee and employer minimum contributions may be phased in over a transitional period, whereas DB or hybrid schemes may defer automatic enrolment until the end of a transitional period (30 September 2017) provided certain conditions are met.

The current legislation allows an employer offering a hybrid scheme (one which provides DB and DC benefits) to postpone automatic enrolment until 2017, even though jobholders would only be eligible to accrue DC benefits. This was not the Government's intention.

> The regulator is now required to minimise any adverse impact on the sustainable growth of an employer when exercising its functions in relation to scheme funding

On 19 December 2012, the Government announced that it would introduce retrospective legislation to clarify the law. The Act therefore provides for the DB transitional arrangements to apply only where DB benefits will be offered. Similarly, a DB scheme which is a qualifying scheme by virtue of satisfying the DC quality requirement will not be able to postpone automatic enrolment for the transitional period.

Instead, DB schemes which satisfy the DC quality requirement, and hybrid schemes which will offer DC benefits to jobholders, may take advantage of the DC transitional arrangements.

As the legislation will have retrospective effect, any employer who has already deferred automatic enrolment will need to take action to enrol jobholders. They will also need to backdate contributions to the later of 19 December 2012 and their staging date. The jobholder will be able to choose whether they wish to pay their own contributions for the same period.

New statutory objective for the regulator

Concerned to ensure that regulation of DB schemes did not inhibit investment and growth, in January 2013 the Government issued a call for evidence which, among other matters, suggested a new objective for the regulator. It proposed that the regulator be required to consider the long-term affordability of deficit recovery plans to sponsoring employers.

No longer in its original form, but with the same mischief in mind, the Act introduced a new objective for the regulator, which came into force in July 2014. The regulator is now required to minimise any adverse impact on the sustainable growth of an employer when exercising its functions in relation to scheme funding.

A revised code of practice on scheme funding, which takes account of this new objective, is also now in force.

Pension Protection Fund – increased compensation cap for long service

The Pension Protection Fund (PPF) provides compensation to members of eligible DB pension schemes, when there is a qualifying employer insolvency event, and there are insufficient assets in the pension scheme to cover the PPF level of compensation.

At the moment, anyone under a scheme's normal pension age when the employer becomes insolvent is paid compensation based on 90% of their expected pension, subject to a maximum cap (the "compensation cap").

Following the collapse of car parts firm Visteon in 2009, the operation of the PPF compensation cap was reviewed. Responding to concerns that the cap did not recognise long service, the Act provides for the current compensation cap to apply to individuals with up to 21 years' pensionable service. For anyone with 21 or more full years' pensionable service the cap will be increased by 3% for each full year over 20 years, up to a maximum of twice the compensation cap.

Current compensation payments for both members and their survivors will be recalculated to take into account the increased cap for long service, and revised payments will be made going forward. However, there will be no backdating, except in respect of certain terminal illness lump sums.

The Act will introduce transitional provisions for schemes which are already in the assessment process when the new cap is introduced. Broadly,

- trustees will have to increase pension payments to take the new cap into account
- calculations (including asset allocation on a wind-up) will be made on the original basis

Potential prohibition of incentives

In November 2011, Steve Webb confirmed his intention to "crack down" on bad practice in relation to incentive exercises. To achieve this, he tasked an industry working group with improving the standard of such exercises, "while preserving [them] as a legitimate tool for sponsors to help manage the liabilities in their [DB] pension schemes". The result, a non-statutory code of "good practice", was published in June 2012.

For the purposes of the code, an incentive exercise is "an invitation or inducement…provided to a member to change the form of their accrued [DB] rights":

- with the objective of reducing risk or cost for the pension scheme or sponsor(s); and
- where the invitation or inducement is not ordinarily available to members of the pension scheme

While research indicates that the industry has responded well to the code of practice, the Act introduces a power for regulations to be made to prohibit the offering of a financial or other advantage to induce an individual to transfer their benefits out of a DB scheme, or to purchase an annuity.

However, if this power has not been exercised within seven years of its coming into force it will be repealed.

Next steps

The Act introduces a raft of changes, but it is worth remembering that they are not all in force, and some will not be for a fair while yet. Trustees and employers should therefore assess the priorities for their scheme(s) and act accordingly.

The provisions in respect of the single-tier state pension and the abolition of DB contracting-out will generally come into force on 6 April 2016. However, the majority of the Act will be brought into force by order, at as yet unspecified dates.

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