INTO THE TWILIGHT ZONE: THE FUTURE OF PENSIONS IN THE UNITED KINGDOM

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This is the first in an occasional series of articles on national issues relating to pension funds. Efforts at the co-ordination of laws relating to pension funds, in Europe at least, have not met with great success, and it is hoped that the greater understanding which will be brought about through this series will assist in the promotion of increased cross-border co-operation. The need for change to the laws relating to pension provision, particularly as a result of increasing demographic pressure, has never been greater. 1 This article looks at the situation in the United Kingdom. Misunderstanding of the Maxwell affair, particularly on continental Europe, is believed to have contributed to the recent failure to agree a Pension Funds Directive, and this comment concentrates on the real issues behind the UK proposals for pension reform.

For students of the law relating to pension schemes, the events surrounding the raiding of the Maxwell pension funds are of prime significance. They encompass many of the vital issues which relate to pension schemes, not least of which are pension fund investment and administration. The case acknowledges starkly that some areas of the law and practice relating to pension schemes are in some ways inadequate and it is partly in response to this affair that the White Paper, 'Security, Equality, Choice: The Future for Pensions', published by the Government in June 1994 has been issued. The value of pension funds in the United Kingdom is not to be underestimated, as the total value of pension fund assets represents one-quarter of the value of all personal wealth in the United Kingdom and therefore is of fundamental importance to many employees, pensioners and companies (see the White Paper).

The embryo for the White Paper was the Report of the Pension Law Review Committee chaired by Professor Roy Goode ('the Goode Report'). His report in September 1993, which was widely welcomed, itself arose as a result of a recommendation by the House of Commons Select Committee on Social Security for an in-depth review of pension law reform following its own investigations into the ownership of pension funds. Its investigation was partly in response to the decision by the Court of Justice of the European Committees (‘CJEC’) in Barber v Guardian Royal Exchange Insurance Group 2 and partly in response to the Maxwell pension fund scandal.

The Goode Committee canvassed a wide range of views in its consultative document published in June 1992. The consultative document raised, in all, some 80 specific questions, addressing what the Committee considered to be the main issues of pension provision.

In addition, the Committee visited various countries to investigate, analyse and understand pension provision in other legal systems to determine whether the United Kingdom could benefit from adoption of any of the facets of these other systems. The countries visited included the United States of America, Canada and Australia, and, in addition, there was some discussion with the European Commission in Brussels and with the Irish Pensions Board.

It was considered that the five most dominant issues were those relating to:

1. ownership of surpluses;
2. powers and duties of trustees;
3. information to scheme members;
4. the balance of power between the company and the trustees; and
5. security for pensioners.

The Goode Committee considered that among the flaws in the present law were:

1. the considerable complexity and lack of structure and organisation;
2. the wide powers and discretions in the hands of employers and trustees, such that the interests of the scheme members were not always sufficiently protected;
3. the lack of compensation to cover loss through misappropriation of assets (which may leave scheme members at risk of hardship); and
4. the lack of a regulatory body with overall jurisdiction and the powers to monitor and enforce proper standards in the administration of occupational pension schemes.

The Committee's perceptions were supported by the evidence received from those who submitted their views in response to the consultation. Despite the flaws, the Goode Committee concluded that, for the most part, UK occupational pension schemes are good schemes, properly administered and giving little cause for concern. However, it

1 See, for example, Commission White Paper, 'Financing Retirement Provision in Europe', Centre for European Policy Studies, 1993, and the forthcoming study by the Federal Trust on the same subject.

recognised that fraud has in the past caused damage on various scales to some pension schemes and jeopardised members' funds. It made six key recommendations which attempted to reflect best practice, and were not intended to be a panacea for all the perceived ills suffered by pension scheme law and operation in the United Kingdom. The key proposals were that:

1. Trust law should continue to provide the foundation for interests, rights and duties arising in connection with occupational pension schemes, but should be reinforced by a Pensions Act administered by a pensions regulator;
2. Freedom of trust should be limited so as to ensure 'the reality of the pension promise', to protect rights accrued in respect of past service and to allow members to make appointments to the trustee board;
3. The provision of information for scheme members should be improved, in content, clarity and presentation;
4. The security for members' entitlements should be strengthened by:
   a. Minimum solvency requirements;
   b. Monitoring by the pensions regulator and scheme auditors and actuaries;
   c. Restrictions on withdrawals from surplus; and
   d. As a last resort, a compensation scheme to cover scheme deficits arising from fraud, theft or other misappropriation;
5. On setting up a scheme, the employer should be free to reserve the right to close, freeze or wind up the scheme, to approve or refuse increases in benefit and to reduce or stop contributions, subject to the minimum solvency requirements; and
6. The administrative burdens imposed on employers and scheme administrators should whenever possible be reduced, and flexibility increased, through simplification of the law and its administration. In particular, detailed statutory investment rules should be replaced with a general 'prudent man' standard and statutory investment criteria; there should be a rapid transition towards a single tax system based on the 1989 regime; and there should be a move from excessively detailed and obscurely drafted rules towards more general and clearly expressed statements of principle.

These were far-reaching proposals. Flowing from them, the Goode Report made some 218 recommendations (having considered some 1,700 submissions since it was set up in June 1992), including interests in the pension fund and the use of their pension savings on retirement.

THE WHITE PAPER

The Government accepted the main thrust of the Goode Report's recommendations to provide greater security for pension scheme members and invited views on the recommendations. Following this further period of consultation, the Government decided to follow the great majority of the recommendations, but with important modifications. The resultant White Paper proposes changes to the legislation on this basis, which it hopes will restore confidence in the security of occupational funds, without at the same time forcing employers to cut back benefits or abandon sound schemes. It is intended that the proposals will provide a clear framework of statutory obligation for employers, trustees, managers, professionals and members, and will make it easier for occupational pension schemes to equalise benefits for men and women. It is also intended to give people who have invested in personal pension arrangements more flexibility in the use of their pension savings on retirement.

It was disappointing that the Government postponed consideration of what happens to pensions on divorce, as that has been an emotive issue for some time. It promises however to undertake a detailed research programme in the future.

The Government intends to bring forward legislation to implement these proposals at the earliest possible opportunity and to introduce the majority of the changes from April 1997, although the introduction of the minimum solvency requirement will be phased in over a five-year period from 1997.

The main proposals are considered below.

OCCUPATIONAL PENSIONS REGULATOR

An occupational pensions regulator will be established, funded by an annual levy on occupational pension schemes (the precise structure of which is still under consideration) which will vary with the size of each scheme. The Government's proposal that the cost, estimated to be £10 million per annum, should be met by the private sector is contrary to the Goode Committee's recommendation that the cost should be met by the taxpayer.

The regulator will replace the Occupational Pensions Board (responsible for contracting-out certificates and ensuring satisfaction of the equal access and preservation requirements) and comprise a board with a full-time chairman and at least six part-time members, all appointed by the Secretary of State.

The part-time members will be drawn one each from employers' associations, employees' associations, the life assurance industry and the pension funds industry and two will be chosen for their general pensions knowledge. The board will be supported by an executive office of pensions practitioners and professionals.

The regulator will have wide powers to investigate the activities of suspect pension schemes and its main task will be to ensure pension schemes' compliance with their statutory obligations, although its responsibilities will span the spectrum of pensions law and administration. Among its enforcement powers will be the power to impose sanctions and to suspend and disqualify trustees. The tax treatment of schemes will continue to be monitored by the Pension Schemes Office.

The regulator will depend on information and cooperation from scheme advisers and members. This may provide some ethical dilemmas for scheme advisers, who may be required to breach the confidence of clients.

MINIMUM SOLVENCY REQUIREMENT

At present, there is no overall requirement that pension funds be funded or that they meet a minimum solvency
requirement, although, in practice, most are funded. The White Paper proposes that a minimum solvency requirement, calculated on the basis of the cash equivalent of accrued benefits will be phased in over a five-year period from 1997. This requirement will apply to all defined benefit (final salary) schemes, other than unapproved schemes, which provide benefits in excess of the Revenue limits, unfunded public service and local government schemes. It is designed to ensure that the funding levels result in a healthy scheme for members and that the value of all accrued rights is protected if the scheme is eventually wound up. At the end of the phasing-in period, the minimum solvency level should be reached for all schemes or be funded to reach it within another three years.

Actuarial valuation reports will have to be obtained by the trustees every three years, with annual certificates of solvency being obtained in the intermediary years. If solvency falls below a 90 per cent level, the company must fund it back to the 100 per cent level within three months. This it may do by a cash injection, a cash reserve appropriately ringfenced in the event of the company becoming insolvent, or a guarantee from a recognised bank. The time limits for reaching the 100 per cent levels could be varied, or waived by the regulator on application by the trustees. Trustees will be required to draw up a schedule of payments with the employer and to monitor accurate and timely payments.

There is some concern that trustees may have to revise their scheme's investment policies as a result of the minimum solvency requirement in order to provide greater protection for its members. Although equities are generally regarded as the best performing assets, there is concern that there may be a switch of investments from equities into fixed-interest securities for greater stability and security for members. This may have significant consequences for the equities market, given the size of pension funds holdings in equities. It should be borne in mind, however, that supply adjusts to demand and with the long lead-in time to the biting of the solvency requirement, the markets may well adjust to any consequent reduction in demand.

In response to concern about pension funds holding equities, Mr Hague, the Social Security Minister, indicated in September 1994 that in order to avoid schemes suddenly falling below the minimum solvency floor when there is a collapse in stock prices, pension funds would be able to use an average of equity prices over a period.

COMPENSATION SCHEME

A compensation scheme will be set up, operated by the Pensions Ombudsman with the support of a compensation board. Compensation will be paid from levies collected after an event requiring payment from the compensation fund or from commercial loans pending collection, which event includes the employer's insolvency, dishonest removal of assets through theft, fraud or other misappropriation, and, in the case of defined benefit schemes, the loss to the fund resulting in the scheme's solvency dropping to less than 90 per cent of its liabilities.

The Ombudsman and compensation board will decide whether compensation will be paid. Trustees have an obligation to recover missing assets. If, in the opinion of the Ombudsman and the board, the trustees are not doing all that is possible to recover the missing funds, they have powers to reduce the final compensation payment. Compensation for 90 per cent of any loss, or, for defined benefit schemes, the amount to bring the fund back to 90 per cent solvency, will be paid. However, pensions in payment will be protected before deferred pensions and there may be situations where deferred pensioners receive less than 90 per cent protection.

TRUSTEES

One-third of the trustees of all schemes may be elected by members of the scheme. There should be a minimum of two trustees, unless for small schemes (less than 100 members) it is only practicable to have one. However, where existing schemes have the support of scheme members (for example, schemes with independent corporate trustees or trustees independent of the employer) there will be an exemption from this requirement. Member trustees will be allowed to take time off with pay for training and trustee meetings.

Since the White Paper, the Department of Social Security issued a consultative document in August 1994 containing further proposals on this issue and inviting comments. Among the proposals was the suggestion that employers should hold ballots of pension scheme members on whether they wanted to appoint a third of trustees, as it was recognised that the one-third employee trustee requirement should not apply if the majority of members did not want them. However, there was concern that such a referendum in schemes with a large number of members who were content with arrangements would be cumbersome and costly, and representations were made to the Government on this basis. The view was also expressed that the nomination process for employee trustees should only be triggered where a number of members expressed dissatisfaction with the current scheme arrangements. Mr Hague, the Social Security Minister, said in September 1994 that the Government will implement reforms with these views in mind.

The DSS consultative documents also proposed that employee trustees, once elected, cannot be removed other than by a unanimous decision of the other trustees (or the regulator), even if their employment terminates. This gives some protection to an employee trustee and addresses the problem of potential bullying of such a trustee by a strong managing director who may have, in the past, exercised control over such a trustee through power to appoint and dismiss him.

EMPLOYER ACCESS

Employers may have access to surpluses in strictly defined circumstances and only if members' rights are fully protected. The trustees will decide whether any payment of a surplus is to be made in accordance with conditions provided for in the legislation. Members may request the regulator to intervene in cases where scheme rules allow a payment to be made to employers. Employers will be able to change benefit levels in respect of future service in order to
limit the future liabilities, but they cannot change accrued benefits for past service.

**WINDING UP**

Scheme priority rules on winding up will be overridden by legislation which will ensure that all members receive the value of the cash equivalent of their accrued rights on a pro rata basis if assets are insufficient (without reducing pensions in payment). The balance of assets can then be distributed under the scheme priority rules.

**SEX EQUALITY**

Recent CJEC rulings require that occupational pensions must be the same for men and women in respect of service from 17 May 1990. It has been decided that this is best achieved by breaking the links between the State Earnings Related Pensions Scheme (‘SERPS’ — the additional pensions provisions of the state pension scheme) and guaranteed minimum pensions (‘GMP’ — an obligation of contracted-out pension schemes). At present, salary-related schemes which contract out of SERPS are required to provide benefits at least equivalent to the GMP as a partial substitute for SERPS. As a result of the link between GMP and SERPS and state pension age (60 for women, 65 for men) GMPs for men and women of equal ages are paid on different dates and have different accrual rates. It is difficult therefore to equalise overall benefit levels while remaining contracted-out of SERPS.

Instead, the salary-related contracting-out test will be based on the quality of total benefits provided by a scheme, rather than requiring it to mirror aspects of the benefits which would have accrued in SERPS. The defined contribution test for money purchase schemes will operate unchanged. The new system will be introduced from 1997, when equal pensions for men and women will, however, be able to be paid. Accrued rights in respect of service up to 1997 will continue to be dealt with under the existing system of GMPs and protected rights.

As GMP is to cease in future, the GMP requirements for those paying reduced rate national insurance contributions (which are not yet in force) will be repealed.

**CONVERSION**

Members of personal pension schemes can choose to convert their funds into an annuity if they do so before attaining the age of 75 and those who have retired but have deferred purchasing an annuity may use scheme funds, presumably with various limits to be set.

**CONCLUSION**

The White Paper was, on the whole, well received by the pensions community and makes substantial progress on the present structure of the law and practice relating to pension schemes. It is hoped that the legislation introduced to put the proposals into effect will safeguard the benefits of scheme members, be practical, simplify the existing law, be fair to all parties and will effectively regulate schemes and their administration. However, if the legislation has the effect of reducing fraud on pensioners, then the man-hours spent in considering, making and implementing these proposals will have been worthwhile.

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