# Simplifying Pension Benefits – is it Time for the Pensions Pound?

A Joint Policy Paper between the ACA and Royal London

November 2018

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# 1. Summary

The current defined benefit pension regime is increasingly out of step with other savings opportunities being offered to consumers.

Defined benefit pensions are complicated for members to understand and schemes to administer, and there is little flexibility for members in how they use them to fit their own circumstances. Many of the existing requirements, e.g. for the provision of a spouse's pension and other aspects linked to contracting-out of the State system pre-April 2016 were designed in the 1970s, and no longer reflect how people live their lives.

The rigidity in the system is also stopping employers from consolidating schemes where they could take advantage of economies of scale to improve scheme governance and better manage costs to their businesses.

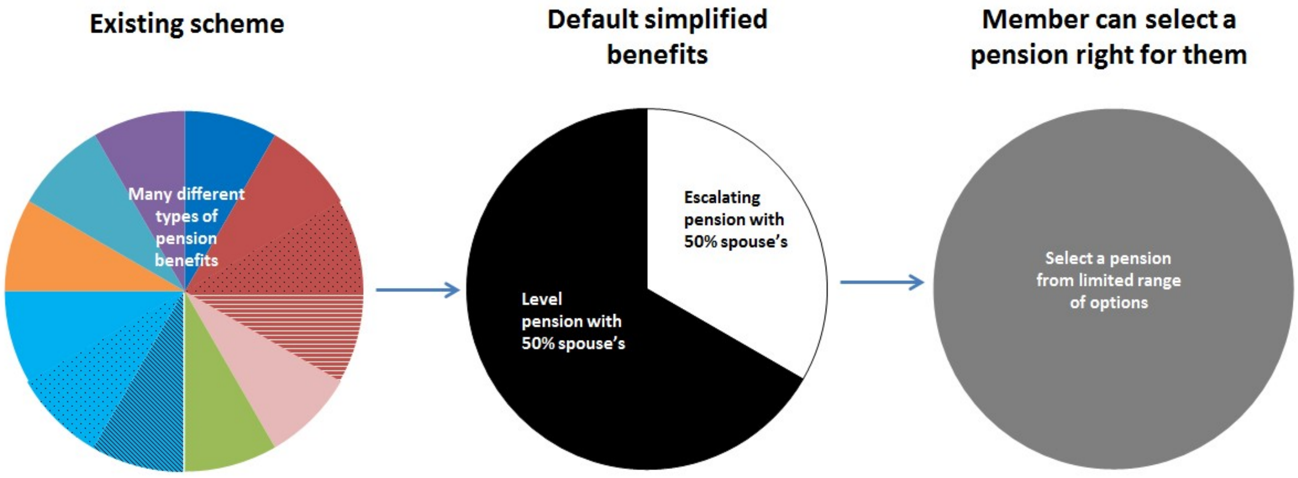
### Simplifying the way DB pensions are delivered offers the opportunity to:

- **allow members to understand their benefits as "pensions pounds" they can use in a way that suits them;**
- **improve the governance of schemes by focusing resources on member engagement and deficit reduction, rather than higher than necessary administration and related costs for historic benefits that have limited meaning for most members;**
- **reduce the risk of administrative errors and misinterpretation of benefit entitlements; and**
- **pave the way for significant consolidation of the DB pensions market, allowing consolidators to operate more efficient schemes to the benefit of members, and allowing employers to concentrate on their day to day businesses rather than the business of running a pension scheme.**

### What would simplification look like?

Simplification does not mean a reduction in the expected value of members' benefits, but rather legislation would change to allow them to be re-shaped. It would be achieved without any reduction in members' headline pensions – indeed the majority would likely see an increase in their pension at the effective date of conversion, although future indexation may then be lower. This is in line with what many members choose for themselves at retirement when they have this flexibility under a defined contribution arrangement.

It is important for simplification to be viable that it is achievable without seeking individual member consents. A scheme would reshape its benefits into a simplified structure such as we have set out in Appendix 3. However, within that process, it would also be possible to give members the choice of a limited range of different options while staying in the DB environment. In particular, schemes might offer a menu of options for members to choose within parameters set out in legislation. So, on simplification, members could have the opportunity to select a pension that works best for them from the choices the simplified scheme offers. For example, would the value of their pension, their “pension pound”, be used to provide some level of indexation for the future, or would they prefer a fixed pension as their other investments give them the inflation protection they are looking for?




The Government has recognised the benefits to DB schemes of converting guaranteed minimum pensions (GMPs) to standard scheme benefits – via the Pensions Act 2007 – although few in practice have gone down this route pending the now released judgement about GMP equalisation. Simplification would essentially do the same thing for the whole of a member’s benefit, including elements of pension that currently have different Normal Retirement Age definitions, within a statutory framework protecting and placing limits on the way benefits could be reshaped. Many schemes might find it beneficial to work on simplification at the same time as GMP conversion.

Simplification offers the opportunity for members to better understand the combined value of their defined benefit and defined contribution pensions, and how their pensions fit with their other savings. It also allows employers and trustees to focus resources on delivering good outcomes to members, rather than grapple with complicated administration and definitions of inflationary increases which are only understood by professionals in the industry. And it would also enable the industry to consolidate schemes to a more significant degree, something that is not realistically achievable under the current pension regime.

Members would still be able to take their pensions at the age they are planning to now, and would be able to decide when it is best for them to take their benefits, based on a clear set of parameters for how their pension will be calculated if they take it early or late.

This paper considers the detail of the current complexity in the system, and how this could be removed by simplification. Technical legal input has been provided by the Association of Pension Lawyers.

# 2. Introduction to the technical paper

- Individuals build up a diverse range of pension rights over their working life – state/private, funded/unfunded, Defined Benefit (DB)/Defined Contribution (DC) and many variations within each category; it is hugely complex to compare the value of each and this means that making informed decisions is very hard, even for the financially informed.

- In particular, DB rights have generally been built up in so many different ways that each scheme can have its own unique structure, and even within one scheme there can be multiple 'benefit slices' reflecting different legislative requirements and typically multiple benefit changes over time – see Appendix 1.

- If these accrued pension rights could be simplified according to a standard legislative framework setting out the necessary protections for members, there would be many potential benefits:

  – Improved member understanding of pension savings, so enabling better retirement outcomes – the ability to understand what your "pensions pound" provides in your DB scheme compared to other pension saving options.

  – Lower ongoing running costs, meaning more money is available to pay for pension promises.

  – Consolidation of DB pension schemes becomes more achievable, leading to the potential for further efficiencies and / or improved governance. In the ACA's 2018 survey, only 2% of employers responding thought simplification would not help in this.

  – Improved accuracy in hedging benefits and so improved risk management.

  – Improved, and potentially accelerated, availability of insurance protection to help secure member benefits.

  On the practical side it would also have the knock on effects of improving the ability for DB schemes to support the pensions dashboard, and would act as a catalyst for cleaning member data, leading to an acceleration of better member service, automation of benefit calculations, and member self-service (including a smoother transfer process where appropriate).

- How pension rights would be simplified, while retaining the necessary protections for members' benefits, will of course need to be considered and managed:

  – It is envisaged that members' benefits would be converted on an equivalent actuarial value basis into a simplified benefit structure using a set of suitable forward-looking assumptions. Even on such a conversion basis, it is possible that the actual benefits paid over the lifetime of the member or dependent beneficiary could be higher or lower under some different scenarios (e.g. members live shorter or longer lifespans than assumed, inflation is higher or lower than assumed, etc.). The simplified benefit structure and the terms around how benefits are converted would need to be carefully designed in order to minimise this risk and give confidence in the process.

- There is no benefit value uplift for individuals. However, it is expected that initial pensions for many members will be higher than at present when they come into payment, as a result of moving to a common approach for future increases. Pensions already in payment would not go down in amount at the date of change.

- Members would still be able to take their pensions at their planned pension age, and there would be more transparency than now on how taking their pension early or late would change the amount of the starting pension (with schemes adopting standard calculation factors).

- The process would need to be clearly communicated - members would need to understand the impact of the exercise on them, and the aim would be that following benefit simplification they would understand their pension better and become more engaged in their pension savings as a result.

- The level of compensation provided by the PPF in the event of insolvency will change as it would be based on the new benefit structure. Whilst this potentially provides different exposure for the PPF, it does have the potential to reduce elements of the existing lottery of how benefits are capped on entry to the PPF. PPF levies may also increase, all else being equal, where members' pensions increase as a result of simplification.

- There will be costs associated with:

  - 'Cleaning up' existing data ahead of a simplification exercise. However, much of this work will be needed in any case, or is already ongoing, including for GMP reconciliation and GMP conversion and in preparation for the pensions dashboard, and is positive for member outcomes. Pension simplification might simply accelerate this work and it can be factored into the employer or trustee's cost-benefit analysis, when deciding whether to go down this route.

  - There will also be actuarial, legal, administration, communication etc. costs arising as part of the process of standardising benefits, however it is anticipated that the long term benefits of simplification will materially offset these.

- Some legislative changes will be required to support benefit simplification, and potentially scheme consolidation exercises:

  - Without some change in tax legislation, the act of changing benefits into a simpler form may crystallise a tax bill for members under annual allowance (AA) and lifetime allowance (LTA) tests.

  - Current legislation around benefit restructuring does not adequately provide for the structural changes that would be needed, and would need to be revised – especially for scheme wide changes where individual member consent is not practical or being considered.

- In the remainder of this technical paper we consider further:

  - Some of the challenges faced by members in understanding their DB pension entitlement, and the opportunity for benefit simplification to increase understanding and engagement on retirement saving and support the pensions dashboard.

  - The potential for material reductions in ongoing costs to arise as a result of this type of benefit simplification, meaning more funds are available to meet the pension promises made and to make pension provision for DC members.

  - Other linked 'wins' such as better member benefit delivery; tighter risk management and the increased potential to secure retirement benefits.

  - The legislative and regulatory changes required to enable benefit simplification to happen, bearing in mind the provisions already in place, eg for GMP conversion.

  - The 'knock on' consequences for the PPF and pension taxation.

  - An outline of a possible standard benefit structure and an overview of the process for converting DB pension rights to this.

  - Some case studies to highlight the current complexity, and consider what simplification could achieve. Linked with the pension dashboard project, there is potential for using this to help individuals understand the relative value of their different pensions across multiple pension arrangements.

  - Some ideas on the value of this approach and the next steps which would be needed to take the idea forward.

- We believe that it is important to make the necessary changes to allow benefit simplification now. DB pension schemes are fast becoming legacy arrangements for many employers, and the knowledge about how they work is disappearing. Making benefit simplification a reality in the near term will allow schemes to draw on these invaluable resources before they lose them, to enable the necessary process of collating all of a scheme's governing documents, and making sure these have been correctly executed and reflected in member data. This will mean greater certainty for members that their benefits are being provided correctly as well as greater clarity about what those benefits are, while at the same time improving the operational efficiency of those schemes.

# 3. DB Benefit Simplification – what is the prize?

## Improved member understanding and outcomes

Changes in working patterns over the last 20 years, in the private sector in particular, mean that few individuals start work at age 16 and retire at age 65 having been employed in the one place throughout their adult lives[1,2]. Even if they had remained with the 'same' employer, benefit changes and mergers & acquisitions, or differences in legislative provisions over time, mean that benefit entitlements are often complex and little understood. As a consequence, employees can have a patchwork of pension provision, spread across a number of DB and DC pension arrangements. Keeping track of these arrangements can be a challenge, and there is likely to be far less understanding about the intricate detail of whether benefits can be taken at age 60, 65 or somewhere in between; how benefits increase from the date of leaving that employer until retirement, and thereafter into retirement and what dependants may be entitled to on death.

Included in Appendix 2 are case studies illustrating the benefit entitlements for 3 DB members who have left service at different points in time, and we contrast the resulting benefit entitlements. The complexity in these examples, which is due simply to legislative change, is clear.

The proposed pension dashboard would go some way to helping individuals understand their total pension saving – across State and private provision – however, we anticipate that it will be many years before data in relation to DB deferred pensions can be robustly collated in such a format. Even then, given the complexities described above, it is debatable whether this will materially help individuals understand how much pension they will receive when they reach e.g. age 65 and how that will increase in retirement.

With the ongoing shift from employer sponsored pension provision, to individual led saving through DC arrangements, it is critical that individuals can understand how many "pensions pounds" they have and how best to use them and top them up if necessary.

Benefit simplification for DB pensions would facilitate this understanding and more generally, help to reduce confusion amongst members of the public about pensions.

## Reducing the costs of administering pension schemes – for sponsors and members

A sponsor (and therefore a DB scheme) has finite resources. There is already evidence to suggest that employer contributions to DC arrangements are constrained by the costs of

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[1] https://www.bbc.co.uk/news/business-38828581

[2] https://www.lmr.co.uk/such-a-thing-as-a-job-for-life-in-the-21st-century/

funding DB arrangements. Indeed, in a recent ACA survey[3], 53% of respondents noted that costs associated with their defined benefit pension scheme were having a negative impact on pay increases. Therefore, simplification of legacy DB benefits will not only help (typically older) members with DB pensions, it will potentially free up time, resources and cash to strengthen the provision for the current, typically younger, workforce. It is also a much needed catalyst for improving the quality of DB pension records.

For every extra £100,000 of costs that a sponsor has to bear in the ongoing operation of their DB scheme, that is £100,000 less that is available to fund DB scheme deficits (and/or make DC provision). Pension schemes operate over very long timescales, and compounding the impact of simplifying benefits over such periods could materially improve current and future funding levels, especially for small schemes.

Improving technology can clearly help in automating member benefit calculations. However, the costs of coding and testing such automation (of benefits which are likely to have a minimum of twelve elements to the calculation, due simply to legislative changes over the last 30 years as summarised in Appendix 1) are prohibitive. Whilst commercial decisions by providers mean that the cost of installing and fully automating the administration of a pension scheme are often not directly borne by the sponsor or scheme up-front, for particularly complicated schemes, it can be commercially unattractive for providers to take on the business at all. This means that despite significant technology advances to date, the majority of schemes are still yet to automate the full range of benefit calculations.

Benefit simplification would accelerate the need for clean data and we comment on this further on page 13. With clean data (in an easily accessible electronic format) and a consistent, simplified benefit structure in place across the industry, installation costs for fully automating administration will largely be eliminated. This would in turn support further development in the pension scheme administration sector and release time and resources which can be spent engaging and delivering to members.

Establishment of a common, simplified benefit structure would mean that full automation of DB schemes – retirement calculations and transfer calculations – can be achieved at a fraction of the cost. Delivery of actuarial valuation results will be cheaper, leaving more capacity to focus on long term objectives and risk management. Most importantly, such routines would be scalable across the industry meaning that the costs of automation are shared. Legal advice on detailed benefit provisions would also reduce materially. DWP’s White Paper suggests that ongoing pension costs could be reduced by 10—15% if benefit simplification could be achieved. We believe that savings will be at least this and in our view, potentially greater when broken down into those arising from using clean data; that from administering simplified benefits and further savings if a next step to scheme consolidation is taken.

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[3] https://aca.org.uk/final-report-aca-2017-pension-trends-survey-report/

## Making pension freedom and choice more readily achievable

There is already evidence confirming that where a single financial advisory firm is appointed to advise on individual transfers out of a DB arrangement, the costs of providing members of that arrangement with regulated advice could be reduced by up to 75%[4] compared to each member finding their own individual financial advisor. Members' experience of taking independent financial advice would be expected to improve where advisers are considering potential transfers from schemes with a consistent, simplified benefit structure, allowing the adviser to focus more on the member's individual position and the likelihood of benefits being paid in full, bearing in mind the covenant of the sponsor of the arrangement they may transfer out of. This will enable members to more easily make better, informed decisions.

As advisers, and pension scheme administrators, we see only too clearly the levels of mis-understanding of DB pension arrangements. This is an issue that the FCA (and others involved in the industry[5]) already recognises. We understand that this is to be addressed with a simplified information note to be provided with every transfer quotation. Whilst this is to be welcomed, it remains to be seen whether further improvements in communication and education are sufficient to address the issues, and significantly aid the advice process.

## Easier to secure benefits through insurance

Benefit simplification could make the purchase of bulk annuity contracts easier. We are aware of many schemes with complex benefit increase structures, e.g. with minimum and maximum pension increase provisions, where it is has appeared relatively costly to secure benefits with an insurer. With a simplified benefit structure in place, there will be greater scope to hedge the benefits more efficiently, reducing the risk of unexpected funding requirements arising due to market movements. Further, with clean data, insurers have greater certainty over the liabilities that they are exposed to. A direct consequence of these points is that reserving requirements for insurers are likely to reduce slightly. As for occupational pension schemes, ongoing administration and member communication will be simpler too. While the cost impact for a bulk annuity may appear small in percentage terms, this may make the difference between a bulk annuity being feasible and not being achievable.

Benefit simplification could therefore become a key element in schemes successfully managing the path to improve long term security for members' benefits more quickly, and open up competition between insurers and new consolidator vehicles by making consolidation a more realistic prospect.

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[4] Financial Adviser, 5 July 2018 – Appointing advisers can cut pension transfer advice cost by 75%

[5] https://www.royallondon.com/Documents/Policy%20Papers/Helping-DB-members-make-better-retirement-choices.pdf

## Reduced volatility for DB pension schemes

There has been an enormous increase in the number of DB schemes hedging some or all of their liabilities, with a threefold increase over the last 10 years[6]. For those schemes running off their liabilities over time, rather than buying out or consolidating, the same benefits of simplification will arise. Despite there being no scalable hedge for CPI benefits at present, projections of benefit cashflows, based on accurate data, will be simpler reducing the complexity and so costs of hedging, and improving the effectiveness of such steps.

So benefit simplification should make hedging simpler, helping reduce volatility for DB pension schemes, and again improve member outcomes by speeding up the process to better long term stability in the financial position of DB schemes.

## Merging pension schemes or transferring to consolidators would be simpler too

For employers with multiple schemes, this could well prove the catalyst for consolidation, further reducing costs and the governance burden for those employers who do not want to pass their schemes to a third party consolidator or an insurer. Differences in benefit structures can currently prove a legal barrier to mergers /transfers[7] of employer's schemes. In practice, even in the cases where scheme mergers are implemented, this is typically achieved by mirroring the existing complex benefit structure constraining the ability to realise the full benefits of consolidation.

Removing these differences would also make the prospect of transfers to industry consolidator schemes significantly more realistic than it is now, and more attractive to smaller schemes. If consolidators are forced to offer multiple benefit structures, reflecting the idiosyncrasies of each scheme wanting to transfer to them, it will be hugely challenging for them to operate successfully in terms of administration. Higher operational costs will ultimately be reflected in pricing, making consolidation less attractive and achievable for many schemes.

According to the Pensions Regulator's DB scheme costs comparison tool[8], the total annual running costs per member for a medium scheme (i.e. 100-999 members) is on average nearly three times that of a very large scheme (i.e. 5,000+ members). Paying higher costs accumulated over the lifetime of a scheme is broadly equivalent to adding around 5% to the medium scheme's liabilities. For small schemes (i.e. less 100 members), the impact is significantly higher. This could mean more member benefits can be secured than is the case at present.

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[6] https://assets.kpmg.com/content/dam/kpmg/uk/pdf/2017/06/no-end-to-growth-in-sight.pdf

[7] Requirements for actuarial certification that transfer credits are "broadly no less favourable" under Regulation 12(1) of the Occupational Pension Schemes (Preservation of Benefit) Regulations 1991

[8] http://www.thepensionsregulator.gov.uk/trustees/your-db-scheme-costs.aspx

# 4. More about what Benefit Simplification could look like

## Making pensions better understood

Few members with DB pensions fully understand their benefit entitlement, the elements which will increase at different rates before and after their retirement, the age at which different parts of their pension may be payable and how these may change over time, e.g. for those with GMP entitlements. Provision of a simple benefit structure will go a long way to address this, and the benefits provided will have the same value (the "pensions pound") across different schemes (based on a standard set out in legislation).

The case studies in Appendix 4 illustrate how simplification could operate in practice.

The potential for members to perceive gains and losses in amounts, even if the benefit is calculated to be of equivalent value, will be a key point to address for benefit simplification to succeed. To give members, trustees and employers confidence in benefit simplification, we believe that it is essential that there is:

- An agreed, industry wide, simplified benefit structure. We have set out some ideas for this in Appendix 3.
- A clear message that members will not have to wait any longer than they are expecting to take their pensions.
- An agreed approach for completing the calculations for conversion, so that trustees and employers can satisfy themselves they have carried out the process correctly, and so members are protected in accordance with the legal requirements.
- Agreement that there are no resulting AA or LTA charges arising simply from the conversion process, and that none of the LTA protections are undermined.

## Changing legislation to adopt an industry framework for simplification that protects members

Rules already exist that enable the re-shaping of member benefits – the GMP conversion legislation (Sections 24A – H of the Pension Schemes Act 1993) and Sections 67 and 68 of the Pensions Act 1995. However, these were not designed with significant structural conversion of benefits in mind.

### *Section 67*

Section 67 is designed to protect members' "subsisting rights" at the date of change. However, amendments are permitted provided certain conditions are met, and one set of conditions requires the scheme actuary to provide an actuarial equivalence statement that the actuarial value of the members' benefits is maintained despite the change (Section 67C).

One possibility is for benefit simplification to utilise much of the procedural mechanics of Section 67C (which also includes informing members ahead of the change taking place) and to be regarded as an additional type of "regulated modification" with its own protections. (Although the mechanics may in practice need to be included in a new Section of the 1995 Act, or eg under Section 68, see below.)

Section 67 as it stands would not be able to deliver the structural reshaping of benefits in accordance with a statutory "standard" (including standard protections for members) and many actuaries have found the approach permissible under Section 67 far from straightforward to apply in practice. By having a standard framework for benefit simplification, trustees and employers can be confident in adopting changes and communicating these to members.

Using an approach consistent with the scheme's cash equivalent basis as section 67 does now may not be appropriate in all circumstances or with respect to all benefits. For example, the benefit (or member option) being changed might not be explicitly valued under the cash equivalent approach being used by the pension scheme in question.

### *Section 68*

An alternative approach to amending legislation to facilitate benefit simplification might be to add a further "prescribed" purpose to Section 68 (under section 68(2)(e)) which allows trustees to amend schemes by resolution (rather than the scheme's amendment power) in certain circumstances. One considerable attraction to this rather than amending Section 67 is that Section 67 (as it stands) would still be subject to any scheme-specific restrictions in the amendment power. Section 68 gives the trustees a free-standing power to amend their scheme – albeit for benefit simplification purposes it may be preferable to include a requirement for employer consent, where the employer is solvent.

Having a statutory power to make benefit simplification changes (on a statutory standard) by resolution would mean that all schemes could potentially take advantage of this, whatever restrictions might be in their individual amendment powers.

### *Contracted-out benefits*

Contracting-out legislation would also need to be changed to facilitate benefit simplification. Regulations 17 and 20 of the Occupational Pension Schemes (Schemes that were Contracted-out) (No 2) Regulations 2015 set out tests to be met if the scheme being amended was formerly a contracted-out scheme. Overall these are more restrictive than Section 67, and there is no automatic requirement for an actuarial equivalence test to be carried out.

In contrast, the GMP conversion legislation expressly provides for GMPs to be converted into other benefits, and does not appear to prevent the reshaping of other benefits, including those that accrued in a different period to the GMP, as part of a GMP conversion exercise. It therefore appears that GMP conversion and wider benefit reshaping should be capable of being complementary processes.

### *Re-structuring benefits on insolvency*

It should be noted that the only pension schemes which can currently access significant structural re-shaping of benefits are those whose sponsor has become insolvent but whose funding level (or additional covenant support under a future arrangement) means that greater than a PPF level of benefit provision is available – either through buying-out benefits above PPF compensation, or offering transfers to a replacement scheme providing lower benefits, but above the PPF compensation level.

Benefit simplification would not reduce the actuarial value of members' benefits, so it would not be removing the funding obligation from solvent employers, but it would open up the advantages of simplification to solvent employers too.

### GMP inequalities can be tackled at the same time as simplification

Trustees and HMRC, together with pension scheme administrators are working hard to meet the deadlines for completing the GMP reconciliation process. Once done, there follows the challenge of correcting benefits, and then schemes are likely to start addressing the GMP inequality issue on post 16 May 1990 service through GMP conversion. As part of this, GMPs are likely to be eliminated on all service. GMPs add significant complexity to any pension arrangement, with the varying means of revaluation before and after retirement, step ups, anti-franking etc etc. The scope to convert GMPs and the benefits that accrued alongside them into simplified benefits, potentially tackling equalisation on post 16 May 1990 service at the same time, has enormous appeal.

# 5. Other benefits of simplification

## Simplified benefits and better data will open-up liability management opportunities for schemes

It is true that for many pension arrangements, overall the member data is expected to be there or thereabouts. Today, member data is often only examined in detail at the point benefits are being quoted or settled and any additional liabilities arising, or surplus released from having over-reserved for the entitlement, is only gradually captured with the passage of time. Whilst this is generally considered acceptable for funding purposes for a pension scheme with an ongoing sponsoring employer, this is not typically suitable when carrying out one-off settlement transactions or other bulk benefit conversions. Neither is it conducive to achieving good member outcomes if members do not have confidence in their pension scheme's records when making decisions about their retirement savings.

DB pension schemes are now largely legacy arrangements for most employers. HR departments with detailed records of the history of such schemes and the idiosyncrasies of some member entitlements are increasingly focussed elsewhere and long serving Pension Managers and Trustees, who remember scheme events, are retiring. If the issue of collating all of a scheme's governing documents and making sure these have been correctly executed and reflected in member data is not tackled soon, it will be increasingly difficult to do this. It has to be better for time to be invested now in completing this governance challenge – and no one should underestimate the issues that might need to be resolved – and it means that the Trustees of the future can be confident that they are administering the right benefits at the right time and have funding plans in place that are adequate to meet the promises made.

Unlocking the ability to simplify benefits, to communicate a clearer message to members, reduce ongoing governance and administration costs (as well as actuarial valuation costs, legal advice etc) and to unlock access to cheaper future hedging, buy-ins or consolidator vehicles, is a price worth paying for some up-front costs to schemes. It is recognised, however, that the cost of preparing clean data in easily accessible electronic format will vary from scheme to scheme depending on its inherent complexity and past history, but even with the status quo, this challenge needs to be addressed to support automation of pension scheme administration.

There would need to be some form of sign off that the data used in the benefit simplification calculations is complete and as correct as possible, subject to suitable levels of tolerance or assurance. We believe that this will have to be provided by Trustee boards, working against a form of guidance which sets out the steps which must be completed. A similar process is underway for GMP reconciliations.

## Can't technology resolve all of the problems arising from complexity?

Technology is only a benefit if the data is good – otherwise it is rubbish in, rubbish out. Further, as almost every pension scheme in the country has slightly differing provisions, there is limited scalability that can be achieved in developing calculation routines. With one, agreed, benefit structure in place, the scalability problem falls away and using clean data, based on the pricing model and experience of some large administrators of DB schemes, we believe that schemes could see savings of between 30% and 50% in their ongoing administration costs alone, depending upon the current benefit complexity and levels of automation.

## Helping members to understand

Were simplification to be achieved, an individual member might conceivably see £1,000 p.a. of pension converted into future pension of £1,200 p.a. in one arrangement and remain at £1,000 p.a. in another. We would expect that in the vast majority of cases the simplified benefit entitlement derived following an approach similar to that described in Appendix 3 will be higher. Also, we envisage there would be a "floor" of the existing pension where the pension is already in payment, and a requirement that non-pensioner members will still be able to take their benefits at the age they are currently planning for. Whilst actuaries may understand the value exchange that has taken place, communicating this to members is critical too.

It is clear that broad industry support for the simplification process is key to ensuring that the industry communicates consistent messages reinforcing why the change is happening and the ultimate benefits it brings to members. Additional support on this from Government may be required.

As matters stand today, the pensions dashboard risks failure in trying the monumental task of consolidating DB pension benefits with a multitude of complex elements of pension; or of only doing half the required job if only DC arrangements are effectively captured by the initiative.

# 6. Other issues to consider

### Do we need a 'small scheme' option?

For schemes with liabilities of sub £50m it may be that the costs of conversion are thought to be prohibitive compared with the anticipated future savings. However, it is exactly these schemes that struggle to meet the up-front costs of benefit automation and member education, and the upside benefits for these schemes post benefit simplification are material. We note too tPR's expectation that the governance of all schemes should be of a high standard, no matter their size. It may be that a streamlined process could be developed to ease the burden.

### PPF levy

Changing member benefit entitlements has the potential to change the level of provision from the PPF, and so the Section 179 valuation of these entitlements.

In particular, PPF compensation in respect of benefits that accrued prior to April 1997 does not increase in payment. One result of simplification could be that a pension with increases that are more valuable than the proposed standard is converted to a higher immediate pension with lower future increases. That immediately increases the "Section 179" liability for that member and the risk-based PPF levy for the scheme.

In one sense, this helps to alleviate the different impacts that presently apply when a scheme enters the PPF. Currently, pensioner A with a £1,000 pa pension carrying 5% p.a. increases gets the same in PPF compensation as pensioner B who has a £1,000 pa fixed pension. In "value" terms, pensioner A's benefits are reduced by perhaps 35-40% of the value of their pension on PPF entry whereas for pensioner B there is no reduction.

By converting the increases to a standard scale (say CPI up to 2.5% pa), pensioner A gets a higher immediate pension (eg £1,200 pa) and, on entry to the PPF a reduction of just 25% (say) of the value of their pension. However, this change from 40% to 25% in the reduction to pensioner A's benefits on entry to the PPF is achieved at the cost of higher overall PPF liabilities and a higher levy for pensioner A's scheme.

In addition, bringing forward payment of future increases (by providing an uplifted pension of £1,200 pa) could lead to cash flow issues for a scheme that has significant pre-97 liabilities with increases more generous than that on the standard scale.

This highlights that, for schemes / employers that are "stressed", simplification of benefits in a way that increases headline benefits may not be a desirable option whether viewed from the perspective of the sponsoring employer or the PPF.

However, for solvent employers, we believe that the savings in ongoing administration costs alone will far exceed any marginal increase in PPF levy. These again can be assessed by the employer or trustee when carrying out a cost-benefit analysis for their particular scheme.

## Pension tax issues

Changing a member's entitlement currently carries the risk of unforeseen tax consequences in the current tax regime – even though the aim of reshaping is that a member overall does not gain. It will be crucial for positive member outcomes from simplification that these are avoided. The consequences currently would be:

- Using up some Lifetime Allowance (LTA) and hence possibly incurring an unexpected LTA charge.
- The possibility that the change invalidates one of the "protections" that a member has against the LTA charge, so risk of a higher LTA charge.
- For a member who has not yet started to draw benefits, using up some Annual Allowance (AA) and potentially causing an AA charge.
- The possibility that a member who left service with benefits revaluing under a scheme provision finds that changed revaluation newly uses up AA, because of losing the carve out that would otherwise apply.
- Causing huge amounts of additional administration whether or not a charge arises: for pensioners, a scheme has to provide statements of % extra LTA used up; for deferred members, statements of AA used up that might otherwise not have to be sent.
- The possibility of some payments from the scheme being unauthorised.

Therefore, it would be essential that the act of converting benefits to a simplified scale is not deemed to trigger any of the above.

It is worth noting that, where benefits are simplified by increasing the immediate pension (but providing lower increases in future) the effect is to bring forward tax receipts. This is an immediate benefit to HMRC and the Treasury.

# 7. Where to from here?

DWP will, we understand, be consulting on the DB consolidation section of the White Paper in Autumn 2018.

We do not believe that the provisions surrounding GMP conversion are adequate to support simplification on this scale, nor are the existing provisions of the Section 67 regulations.

We propose that trustees and employers would be able to agree to make these changes without member consent. If member consent is required, this would not achieve the aim of simplification and would be likely to result in schemes establishing another, albeit simplified, benefit category on top of the existing complexity in place. Members would be protected by the standard procedure set out in legislation – including an appropriate actuarial equivalence test, and by the trustees' fiduciary duties to act in the interests of members overall.

Also, we are not suggesting that sponsors or trustees are required to simplify their scheme benefits – however, with the passage of time, it may become clear that the benefits of simplification are such that employers might be required to 'comply or explain' why simplification is inappropriate.

# 8. Why do this?

Ultimately, every pension scheme is in place to provide the promises made to members during their employment, with Trustees giving oversight to the process over the decades. We believe that simplification has material benefits for the members:

- They can understand their benefit entitlement (their "pensions pounds"), supporting better retirement planning and more informed decision making.
- They can still take their pensions at the age they have been planning to.
- They will receive a better service from their pension scheme administrators (as technology becomes scalable and the data records are robust) and from independent financial advisers who no longer have to grapple with complex benefit designs that differ with each pension scheme.
- The compound effect of ongoing savings – administration, governance, communication, actuarial valuations, legal etc – over the lifetime of schemes, will improve benefit security (even factoring in the costs of data cleansing and conversion). We would recommend that these changes are tackled together with GMP conversion to limit costs and change for the members.
- Scheme funding risks will reduce as hedging and other risk management options (such as annuity buy-ins) can be more efficiently and robustly put in place.

Benefit simplification is not a pre-requisite to DB consolidation, but in reality it will be almost impossible to achieve true consolidation without simplification.

# 9. Where to start?

We believe that some schemes will consider that GMP conversion and benefit simplification can most efficiently be achieved in one exercise, with a one-off communication plan explaining the changes to members (rather than being dealt with as a two stage process). However, there is no absolute need to do this ‘all in one go’. To ensure consistency in treatment of members, and to avoid the potential for benefits to be exchanged on a basis which might be deemed to benefit the sponsor over the member, a single conversion approach should be established – the ‘pensions pound’. It can be easily referenced by all those involved in the project and updated for changing market conditions.

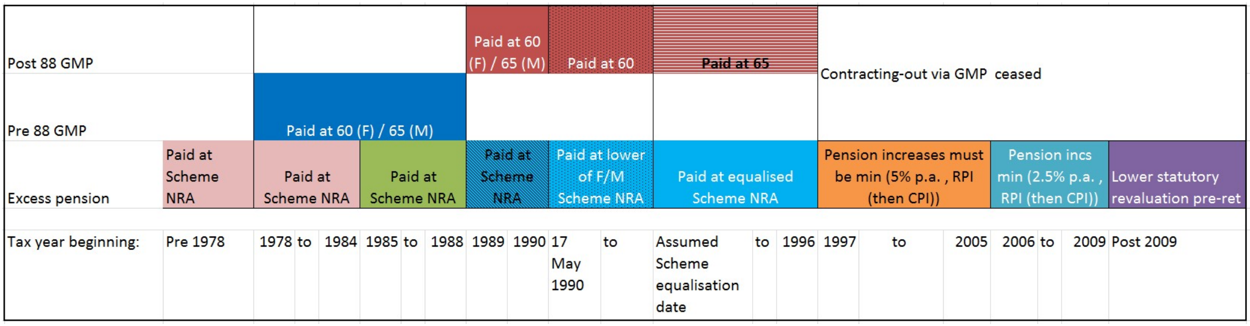
These calculations are not straightforward, but with clarity in the approach to be taken, further efficiencies can be driven through across the pensions industry. The Pension Protection Fund is the perfect example of an efficiently administered consolidator vehicle with a single set of benefits following entry (albeit providing different levels of ‘haircut’ in value terms to different members depending on the indexation rules for their prior scheme).

Our proposed benefit simplification has the potential to achieve enormous efficiencies, without the need for an insolvent employer and whilst preserving the value of members’ expected entitlements from their scheme.

# Appendix 1

## Illustration of current entitlement and benefit slices

A long-serving individual's deferred pension might comprise 8 service-related slices of different entitlement, with some of those entitlements being further sub-divided, resulting in 12 elements of pension.




1. Pre 6/4/78

2. 6/4/78 – 5/4/88 (split into pre 88 GMP and excess)

3. 6/4/88 – 16/5/90 (Barber Day -1) (split into part of the post 88 GMP and excess)

4. 17/5/90 – Scheme Barber resolution day (split into part of the post 88 GMP and excess)

5. Scheme Barber resolution day – 5/4/97 (split into part of the post 88 GMP and excess)

6. 6/4/97 – 5/4/05 (attracting 5% LPI on pension increases)

7. 6/4/05 – 5/4/09 (attracting 2.5% LPI on pension increases)

8. 6/4/09 to date (with revaluation being capped at 2.5% LPI)

It was also typical for many UK pension schemes to apply different Normal Retirement Ages (NRA) to male and female members prior to 17 May 1990 (tranches 1 to 3 above) with a single NRA applying to both from the Scheme-specific Barber resolution day (tranches 5-8) and with the 'best of both' effectively applying between these dates (tranche 4). And this assumes that there have been no other sponsor driven changes to benefit provision along the way!

GMP conversion will potentially consolidate tranches 2 – 5, leaving a minimum of 5 remaining benefit tranches to administer and communicate.

| Pension | Paid at Scheme NRA | Paid at Scheme NRA | | | Paid at lower of F/M Scheme NRA | | Paid at equalised Scheme NRA | | | Pension increases must be min (5% p.a. , RPI (then CPI)) | | | Pension incs min (2.5% p.a. , RPI (then CPI)) | | | Lower statutory revaluation pre-ret |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | | | | | | | |
| Tax year beginning: | Pre 1978 | 1978 | to | 1990 | 17 May 1990 | to | Assumed Scheme equalisation date | to | 1996 | 1997 | to | 2005 | 2006 | to | 2009 | Post 2009 |

Benefit simplification has the potential to reduce this further to 2 benefit tranches, the only difference in these being the rate of pension increase applying in payment.

| Pension | Paid at Scheme NRA | | | Paid at Scheme NRA | | |
|---|---|---|---|---|---|---|
| | | | | | | |
| Tax year beginning: | Pre 1978 | to | 1996 | 1997 | to | Post 2009 |

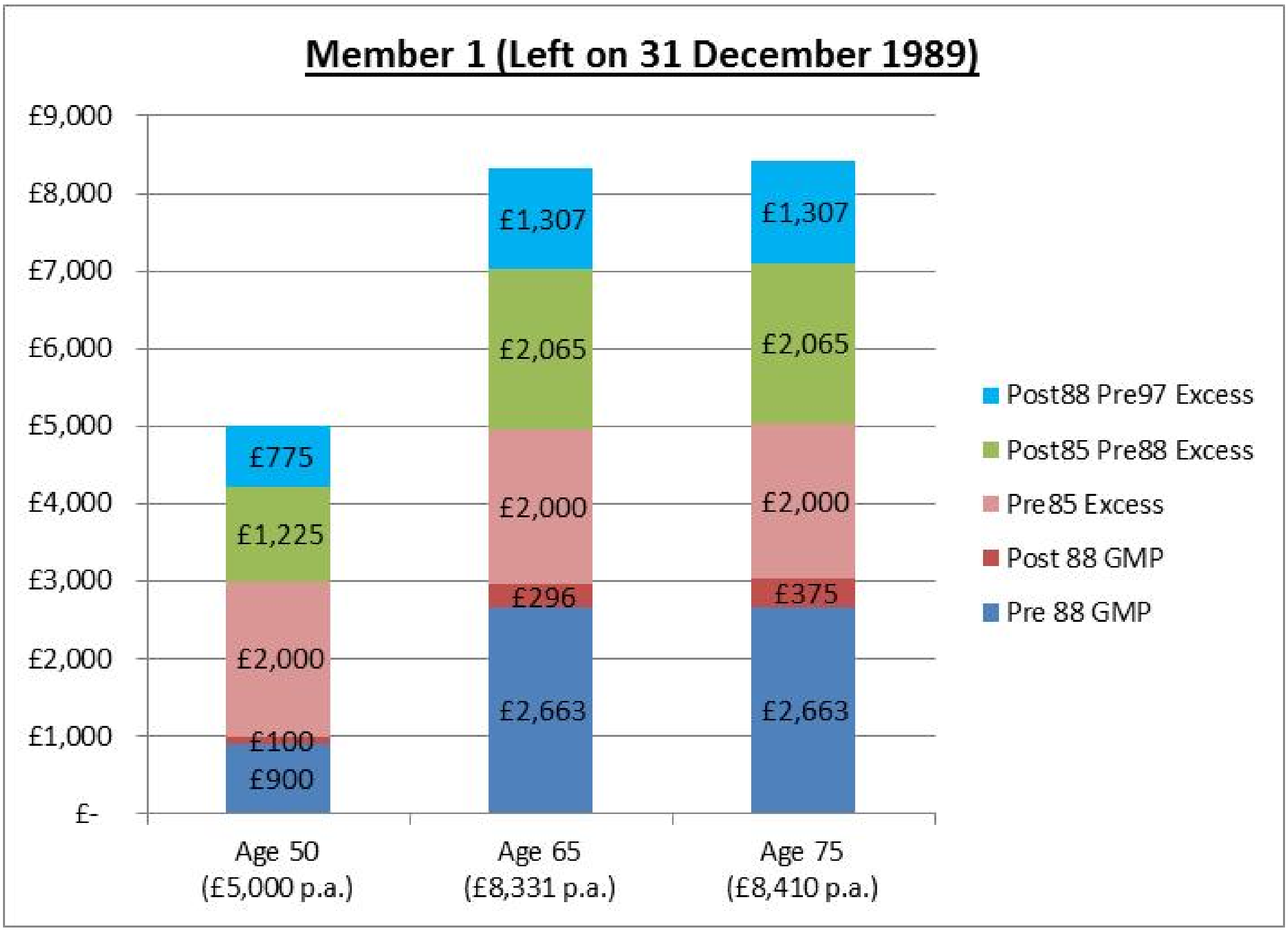
# Appendix 2

## Benefit case study 1

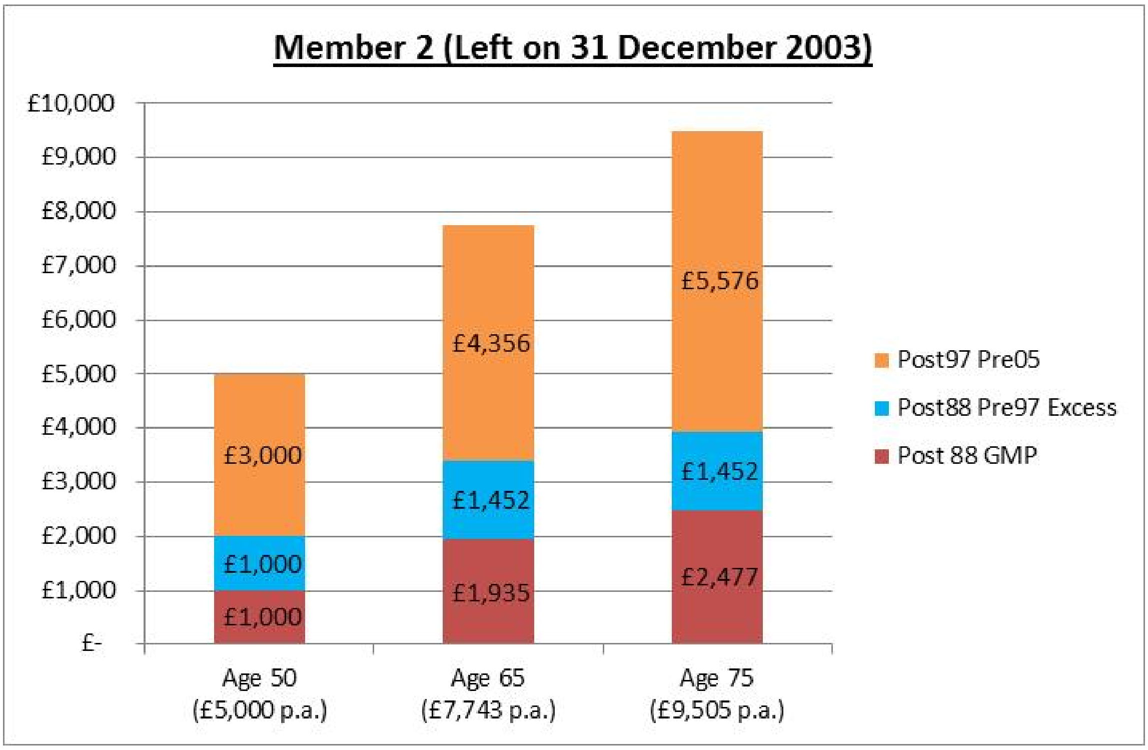
We consider below 3 members, all of whom have a deferred pension of £5,000 p.a. at the date they left their pension scheme having completed 10 years of service and who are aged 50 at exit date.

Making a number of simplifications to the calculations, we consider only the impact of legislative change on their projected benefit entitlement at a single assumed normal retirement age of 65, and in retirement at age 75. The reality is that most pension schemes will have changed the benefit provision at some point, creating further benefit tranches – reducing further the likelihood that members actually understand, and can make retirement plans around, their entitlement.

### Member 1



## Member 2




## Member 3


## Notes on assumptions

All the case studies above assume that the scheme provides statutory revaluation and pension increases. Consumer Price Index increases have been assumed to be 2.5% pa in the future.

# Appendix 3

## An overview of a simplified benefit structure and key points of process

We set out below a candidate simplified benefit structure into which potentially all the benefit ‘slices’ set out in Appendix 1 would be converted. This assumes that Government would permit such a radical restructuring.

An alternative, that the shape of each slice conforms to the legislative minimum that ruled when that slice accrued, would give very little scope to deliver a simplified benefit structure – but at least if GMP conversion (within which GMP inequality resolution was achieved) was applied as part of the simplification, the number of potentially different benefit elements could reduce from 12 to 5/6.

We assume that it would be possible to reshape any sponsor-driven changes to benefit provision that are on top of any legislative minimum.

### Benefit structure

**Normal Retirement Age** – for pensions in payment, this is not relevant. For non-pensioners, we suggest that **one** of the existing NRAs applicable in a given scheme is retained, again to ensure limited steps up and down in benefits.

Alternatively, NRA could just be set at 65 for all benefits, for men and women.

**Benefit increases**:

- Before retirement
  - Nil
  - In line with CPI, min 0%, max 2.5% p.a.
- After retirement – three options, with benefits converted to the increase most similar to that currently in place
  - Nil
  - In line with CPI, min 0%, max 2.5% p.a.
  - In line with CPI, min 0%, max 5% p.a.

For a current pensioner – a non-increasing pension would continue to be paid without increases. An increasing pension would be converted so that only one rate of future increase applies.

For a current deferred pensioner – all benefit tranches with differing rates of revaluation pre-retirement would be converted to pension with the above rate of revaluation. Complexities such as anti-franking would also be removed in the benefit conversion.

**Dependant's pension**:

- Before retirement – 50% of the deferred pension revalued as above to date of death
- After retirement – 50% of the pre-commutation pension in payment at death assuming no commutation at retirement

Pensions are payable to legal spouses; civil partners; individuals with financial dependence on the member.

Children's pensions in payment continue without change. Any new children's pensions are 25% of the spouse's pension payable to up to 4 children (or split pro-rata if there are more than 4 children).

**Early and late retirement terms:**

Not allowed for in benefit conversion, but permitted in day to day of administration.

Early retirement factor is $0.95^t$, where t is the complete years and months from early retirement date to NRD, applied to the benefit revalued to ERD.

Late retirement factors are $1/0.95^t$, where t is the complete years and months from NRD to late retirement date, applied to the benefit at LRD.

**Commutation terms:**

Not allowed for in benefit conversion.

Factors are cost neutral, on a market related basis, and published annually by a recognised body.

**Discretionary benefits; benefit options:**

To be determined under current rules provisions.

## Overview of process

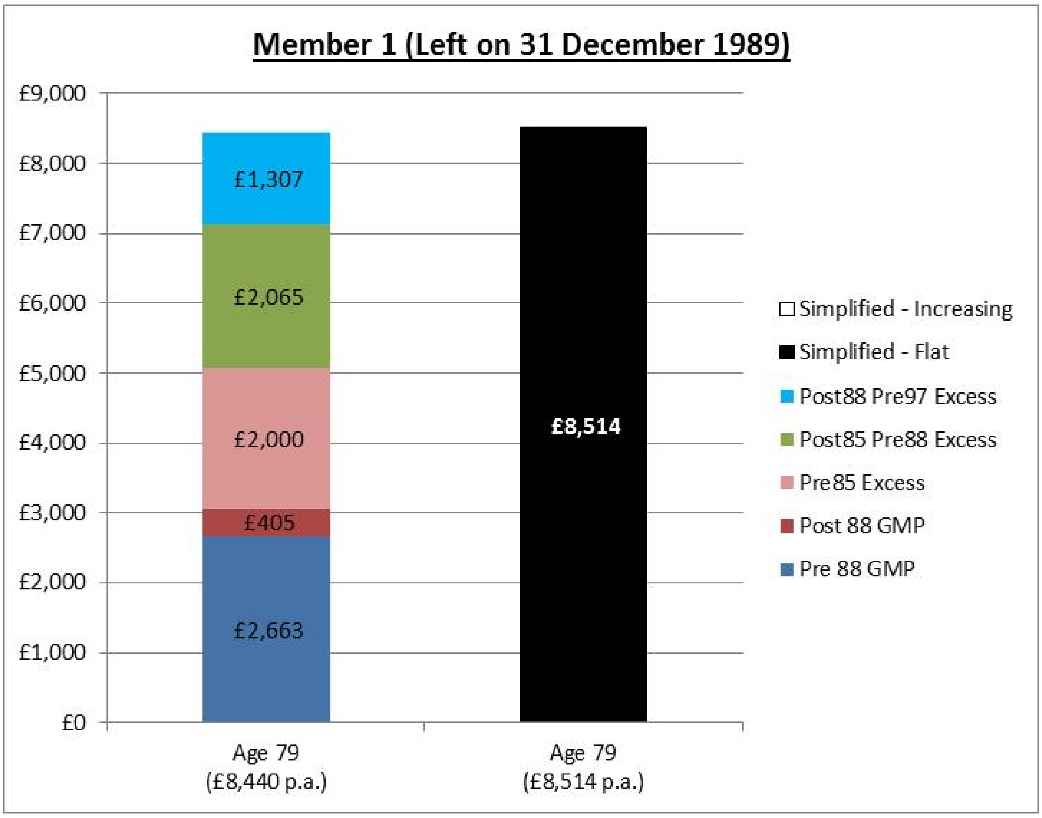
- Employer and trustee agreement is needed to start the process.
- Trustees have a duty to have a Scheme Actuary carry out the actuarial equivalence test.
- Trustees communicate with members on the options and rationale (tPR guidance on what good communication looks like would be helpful).
- Legislation sets out a standard framework for actuarial equivalence.
- Actuarial guidance sets out the approach to be taken by the Scheme Actuary.
- An actuarial certificate is provided to the Trustees confirming that the actuarial equivalence test met.
- Trustees are then in a position to proceed and communicate this to members.

# Appendix 4

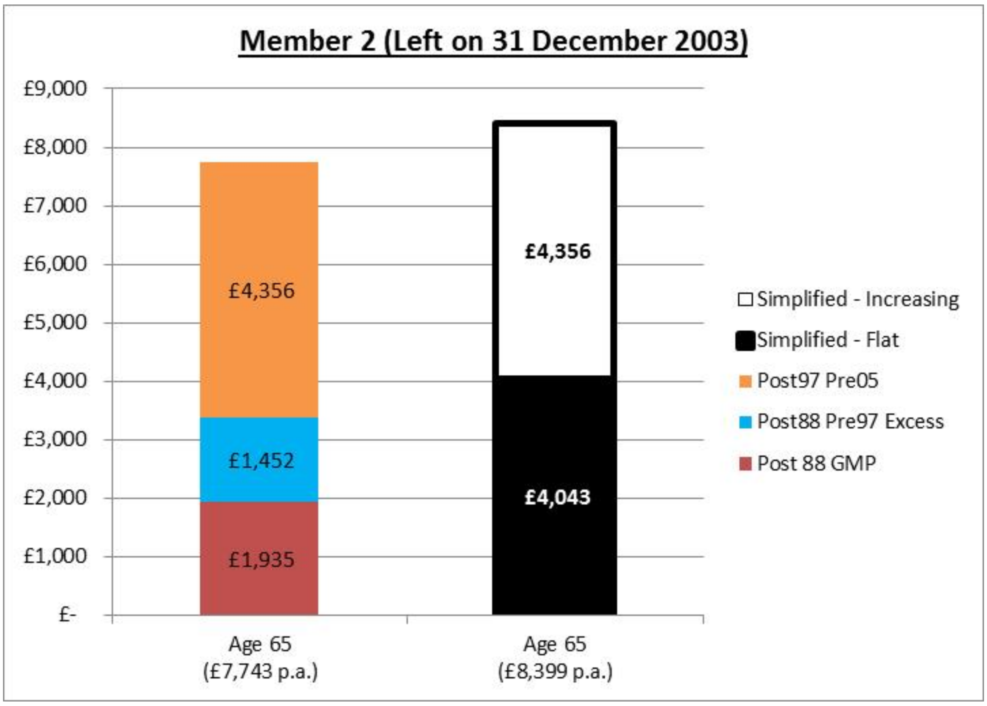
## Benefit case study 2

Building on the case studies in Appendix 2, we further consider how their benefits in payment now (Member 1) or at retirement date might look post simplification.

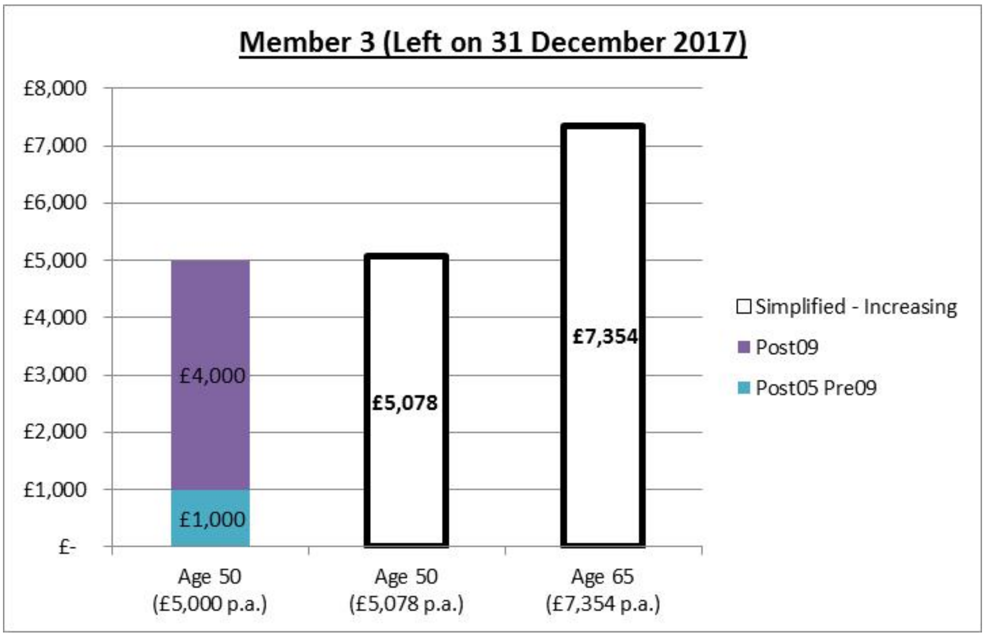
### Member 1



## Member 2




## Member 3




## Notes on assumptions

Where an assumption is required to calculate the simplified pension this has been done using the PPF's latest assumptions guidance, A8. The assumptions have been derived at an effective date of 31 July 2018. In addition all members are assumed to be male and no allowance has been made for expenses of conversion or for members commuting benefits for cash. An approximation has been made for children's pension through a 10% uplift on the dependant's proportion.

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