ASSOCIATION OF CONSULTING ACTUARIES

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Nick O'Neill
PPF and NEST Partnership
Private Pensions Policy and Analysis
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Dear Nick

Draft regulations to allow the Pension Protection Fund to take account of bridging pensions

I am writing on behalf of the Association of Consulting Actuaries in response to the above consultation.

Our comments on the specific questions raised in the consultation are set out in the Appendix.

Although you are silent on this, it does appear to us that the proposals to address bridging pensions are a necessary and pragmatic fix because of the British Steel Pension Scheme and as such don't address wider questions about PPF compensation, including the other anomalies that exist. We would urge you to take this opportunity to widen the scope of this review, and would be happy to discuss and elaborate on the other anomalies which we believe ought to be tackled.

We have a concern that the smoothing proposal, while potentially simpler than paying a temporary bridge, could in some cases cause genuine hardship. We note that the PPF already has the facility to cease pensions at a specified age (specifically children's pensions). Therefore we urge further consideration of a bridging option. We elaborate on this in our response. However, we do agree that either a bridge or a smoothed alternative is preferable to the current position.

We hope that you find the contents of this letter of assistance. We would be happy to discuss them further if that is helpful, in which case please contact me on 020 7432 6635 (david.everett@lcp.uk.com), or my colleague Kenneth Donaldson who prepared this response on 07462 916 483 (kenneth.donaldson@quattropensions.com).

Yours sincerely

David Everett
Chairman, Pension Schemes Committee
On behalf of the Association of Consulting Actuaries Limited

Sent by e-mail to: bridging.pensionsconsultation@dwp.gsi.gov.uk

APPENDIX

Draft regulations to allow the Pension Protection Fund to take account of bridging pensions

1. Do you have any evidence on how many schemes offer bridging pensions as part of their defined benefit pension scheme? Are bridging pensions typically offered as an option where scheme members opt in to take their benefits in this way, or as an automatic right?

In our experience only a minority of the schemes have offered a bridging pension (even though many had an offset to pensionable salary designed partly out of consideration of integration with the State Pension). However, in the minority of cases where a bridge was offered, it was quite likely to be the default position, rather than an option akin to exchange of pension for cash or additional spouse's cover.

2. Do you agree that the smoothing approach is an appropriate way to deal with an individual's bridging pension under the PPF?

We acknowledge that either the step-down or smoothing represents an improvement on the current position.

We appreciate the argument that the PPF administration processes may require reasonably significant modification to monitor and apply future step-downs. However, we note that the PPF already has a facility to pay children's pensions which cease on a specified future date / age. We therefore suggest that the complexity may not be as great as to eliminate the bridging option entirely.

It should be noted that for those with bridges in payment at the assessment date, the drop in pension under the smoothing proposal could be large in percentage terms. This is because our experience is that schemes with bridging pensions often have relatively low earners, so the "bridge" is important to them.

As a hypothetical example consider someone retiring at 60 with 35 years' service. Final Salary was say £30,000. The pension formula is based on 60ths of Final Salary less 40ths of a state pension offset of £6,000 (around the level of the lower earnings limit or the basic state pension). This gives a pension of 35 / 60 x £30,000 less 35 / 40 x £6,000 being £12,250 per annum. In addition the bridge of 35 /40 x £6,000 being £5,250 per annum is paid until age 65. The headline rate of pension is therefore £17,500 per annum, until age 65. The "smoothed" equivalent of the bridge might be in the order of £1,000 per annum (for example). Thus, on the assessment date, the member's pension is reduced from £17,500 to (£12,250 + £1,000) x 90% which is £11,925 per annum. The reduction is 32% in this example and would be more if Final Salary was lower.

Removing / smoothing the original bridge defeats the original purpose of the scheme's integrated design, will give rise to communication issues (to say the least), and to the possibility of real hardship, at least temporarily until the state pension is put into payment. In other words, it could cause the exactly sort of temporary cash flow / financial issues that the design of the original bridge was intended to obviate.

It should also be noted that the smoothing route is likely to be (marginally) more expensive than the step-down method. This is in fact illustrated by your example of Member B, who is caught (temporarily) by the compensation cap under the step-down approach, whereas under the smoothed processes, the cap does not bite. We accept this is a marginal consideration.

Thus, the step-down route is likely to have a marginally lower long term cost and also be preferable to members. Given the existing ability to pay temporary children's pensions, we believe the complexity may be overstated. In all, we urge further consideration of the step-down approach.

3. Are you aware of any potential unintended consequences, for individuals or scheme administrators of smoothing PPF member's compensation amounts in future?

See above. Members with bridges in payment at the assessment date could suffer a considerable reduction.

If the smoothing proposition is selected, we do urge that the PPF monitors the reality of these reductions closely and over the coming 3 to 5 year period should be prepared to review the process, with a possible eye to switching to a step down approach if it emerges that real evidence of hardship is emerging. We appreciate that this would require further changes in the law, as this power is not currently drafted into Schedule 7 of the Pensions Act 2004.

4. What administrative tasks would need to be undertaken by schemes or sponsoring employers to provide PPF with the additional information needed to reflect step downs? We would also be interested in any evidence that schemes or sponsoring employers can provide on the estimated cost of providing this additional information as well as estimated costs incurred through any additional actuarial calculations.

For a step down approach information would be needed as to end date, the current amount of bridge split into pre and post April '97 elements, (possibly) the attaching spouse's entitlement on death during the bridge period, and for deferred pensioners, the date on which entitlement to the bridge first commences.

(Generally, our experience is that the bridge is "single life" and does not carry an attaching contingent spouse's pension, consistent with the original design ambition of state integration.)

It is not clear that there would be "additional actuarial calculations" required for a step-down approach, other than a potential change of actuarial valuation procedures around the PPF levy (section 179) or PPF entry (section 143) calculations. If in fact the question regarding additional actuarial calculations is intended to refer to the smoothing procedure rather than the step-down one, then these should not be significant; indeed, if the PPF supplies the actuarial factors, which seems to be the intention per the section headed "Smoothing in practice", the calculations could then be done by the administrative team.

The cost increase of the additional work should be marginal as a percentage of the overall current cost of assessment.

5. Would schemes or sponsoring employers incur any other direct or indirect costs associated with the proposed change?

We envisage potential additional costs of communicating with members who suffered a larger than expected reduction, as discussed above.

6. The regulations as currently drafted do not cover active members as the PPF already has the discretion to calculate compensation for this group. We believe that this is sufficient to deal with bridging pensions for active members, but would welcome respondent views on this matter, and any evidence that they can provide on how active members' accrual rates are defined in scheme rules where there is an automatic right to a bridging pension.

Our reading of the PPF discretion in relation to active members, as set out in paragraph 8(7) of Schedule 7 to the Pensions Act 2004, is that it only relates to where it is not possible to identify one or more of AR, PE and PS in the accrued amount formula of AR x PE x PS. We are not aware that this discretion can be used to reflect into PPF compensation a scheme entitlement to a temporary scheme pension not related to pensionable earnings (eg because it is linked to the basic state pension or lower earnings limit). In any event we feel that legislation should make clear how such pensions are to be treated going forward, whether through continuation of the bridge treatment provided for by the scheme (which, on balance we advocate), or through a smoothed approach.

7. If the Government were to proceed with the smoothing approach, do you agree that the regulations as currently drafted meet the policy intent? And if not we would welcome evidence or comments on the changes required.

Paragraph 28 (b)	This appears effectively to define the <u>whole</u> pension as a bridging pension. It may be preferable in the drafting to distinguish between the (non-reducing) core element and the temporary bridge element. However, given that subsequent references in Paragraph 32A are to the amount of reduction to pension, not bridging pension, this point may be moot.
Paragraph 32A(2)	When setting the actuarial smoothing factors we note that there is no requirement to consider any attaching spouse's entitlement and how it might operate, if indeed one is present. We infer that it is intended that the actuarial factors will look at the value of the remaining bridge versus a whole life pension, without considering contingent rights. In principle this would appear to be an acceptable approach. However, in the absence of any detail on the actuarial approach it is impossible to comment further, save to say that the PPF Board should additionally consider preserving the pre / post '97 accrual split when applying smoothing to a bridge.

8. Do the regulations as currently drafted enable PPF compensation to reflect all bridging pension arrangements that you are aware of?

By definition and design the PPF is a broach church. Within reason therefore an approximate approach to smoothing of a bridge is appropriate. In practice, the draft regulations appear to give the PPF Board a very wide discretion on the valuation and smoothing to be applied, as paragraph 32A(2) whilst setting out what must be considered, in no way fetters further elements from being taken into account.

9. Do you have any views how many people are affected the issue of GMPs and PPF compensation?

There may be an issue for schemes with Normal Pension Age (NPA) before GMP age (60 for women and 65 for men), where GMP revaluation is only applied from GMP age under the scheme rules. In our experience this applies to a minority of schemes only, but, as the following example shows, the effect can be large.

Our understanding is that if such a scheme actually goes into the PPF then the compensation would not include any GMP revaluation in these circumstances for deferred pensioners – even though the section 179 valuation would include revaluation to date of valuation.

Therefore, there is scope for a member to lose out significantly. An extreme example might be a member leaving at the start of 1988 with a GMP only pension of £1,000 pa. The hypothetical member is now aged 59 at the PPF assessment date, with a NPA of 60 and a GMP age of 65.

This member's compensation would then be based on £1,000 pa only (the pension at exit) even though they would be expecting a pension of almost £15,000 pa from GMP age (with 8.5% increases in deferment).

In addition the scheme would have been paying a levy based on a higher figure too.

We would urge the PPF to consider a solution to this. One method would be to calculate the compensation in a similar way to the section 179 valuation and include the GMP revaluations for deferred pensioners even if these are not payable until GMP age under the rules.

Another group that will be affected are those who chose to retire early, but, so that the scheme can meet its obligation to pay revalued GMP at GMP payment age, the early retirement pension up to that age has been reduced (by more than the early retirement factor would otherwise require). We are aware of a number of schemes that permitted early retirement on such a "stepped" basis. In these cases the "ordinary" reduced early retirement pension plus future increases to 60 or 65 was insufficient to cover the GMP. The Trustees therefore permitted a further reshaping so that a smaller early retirement pension was offered such that, even after the GMP test and step-up was applied, there would be no expected funding strain. This was usually done on an ad hoc basis for a relatively low number of people, but nonetheless was not uncommon. (As an example, say the "ordinary" early retirement pension at 55 was £500 pa, which with increases in payment would fail to cover the GMP at GMP age of £700 pa. Instead, the member was offered a pension of perhaps £200 pa stepping up to the GMP level from GMP age. The overall value of this package was calculated to be equivalent to the member's strict entitlement from NPA.)

Some schemes went further and permitted this "stepped" shape in order to facilitate the member additionally taking pension as cash. In extremis, a cash lump sum plus an early retirement pension of nil was paid, which would step up at 60 or 65 to the full level of the GMP.

We would suggest that these practices tended to be historic, and such members have probably largely reached age 60 or 65, in which case, the issue is not relevant for the PPF. We would anticipate fairly low levels of cases remaining. It would probably be the exception rather than the rule.

10. Do think that PPF compensation should take account of increases in the member's scheme pension which would have taken place at GMP age (60/65) in respect of the GMP requirements in future? If so, we would welcome evidence for your views

We do not have evidence that there is a widespread problem in this area, but as the example given in Q9 above shows, the effect can be very considerable, and we believe (as suggested) that a solution should be put in place. There may indeed be some people as described above with a potentially large step up at 60 or 65 who stand to lose out considerably in value terms under the present regime, such that their total compensation could indeed conceivably be less than 50% of the value of their full entitlement.

The PPF itself is probably in the best place to gather this data from schemes entering assessment, to judge the scale of the issue over the next couple of years.

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