EXPLANATORY MEMORANDUM TO

THE PENSION PROTECTION FUND (ENTRY RULES) REGULATIONS 2005

2005 No. 590

1. This explanatory memorandum has been prepared by the Department for Work and Pensions and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 The Board of the Pension Protection Fund ("The Board") is established by section 107 of the Pensions Act 2004 (c.35) ("the Act") to provide compensation for members of eligible occupational pension schemes in the event of the insolvency of the scheme's sponsoring employer and where the pension scheme is underfunded at a certain level.

2.2 These regulations set out the criteria by reference to which a scheme is to be an eligible scheme. This includes eligibility to both pay the Pension Protection Fund ("PPF") levies and receive protection from the PPF should the sponsoring employer of the scheme go insolvent leaving the scheme underfunded.

2.3 The assessment period is the time where the scheme is assessed to determine whether the Board must assume responsibility for the scheme, whether it is possible to rescue a scheme or whether a scheme must be required to wind up. These regulations provide the rules and requirements for insolvency practitioners, trustees and the Board during this time. The instrument makes certain provision in respect of multi-employer schemes[1].

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 There is an irregularity in the numbering of this Statutory Instrument with reference to the numbering of the Pension Protection Fund (Eligible Schemes) Appointed Day Order 2005. (See the footnote reference to the Order on page 5, footnote (d) of the draft Pension Protection Fund (Entry Rules) Regulations 2005). This was because the Instrument was assigned a number in advance of making in order to facilitate the finalising of a number of other Statutory Instruments

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[1] "Multi-employer scheme" means an occupational pension scheme in relation to which there is more than one employer.

which contain footnote references to the Entry Rules regulations. Because this Statutory Instrument refers to the Order it was necessary for the Order to be made before this Instrument; however the Entry Rules SI has a lower number than the Order. We can confirm however that these two Instruments were made in the correct order.

4. Legislative Background

4.1 The Act received Royal Assent on 18 November 2004.

4.2 This is the first use of these regulation making powers under the Act.

4.3 These regulations include regulations on eligible schemes. Some of the provisions in these regulations are required to come into force from 1st April to ensure the Occupational Pension Schemes (Levies) Regulations 2005 which refer to eligible schemes can take effect from the 1st April. The Occupational Pension Schemes (Levies) Regulations 2005 are required to take effect from the 1st April as this is the start of the PPF financial year. The remainder of the provisions in these regulations will come into force on 6th April 2005.

5. Extent

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

6.1 Not applicable.

7. Policy background

7.1 Section 126 of the Act makes provision about which occupational pension schemes are eligible schemes. This section provides for money purchase schemes to be excluded from being eligible for the PPF, the section further provides for regulations to exclude certain defined benefit and hybrid schemes from being eligible for PPF protection, therefore exempting them from payment of the PPF levies. Broadly speaking, schemes which are not eligible for the PPF are schemes which already have very secure provisions for the protection of their members' pensions. The likelihood of such schemes' requiring PPF assistance is zero, and for this reason it is considered that such schemes should not have to pay the levy.

7.2 These regulations further provide that where, outside of an assessment period, the trustees or managers of a scheme enter into an agreement with the sponsoring employer to compromise the debt owed to the

scheme, this action will render the scheme not eligible for the PPF except in a limited set of circumstances. This is intended to discourage low compromise agreements (which have been frequent in the past), it is also intended to protect the PPF from having to take on responsibility for a scheme with minimal assets and no recourse to chase any further monies from the employer.

7.3 The assessment period is the time where the scheme is assessed to determine whether the Board must assume responsibility for the scheme, whether a scheme rescue has occurred, or whether the scheme may be required to wind up. If an eligible scheme ceases to be eligible in certain circumstances after it has entered an assessment period (for example because one member of a 2 member scheme dies), the provisions governing the assessment period would, but for provision in these Regulations, no longer apply. These regulations provide for this situation by enabling the Board to continue to assess whether the scheme has sufficient assets to meet the protected liabilities and whether a scheme rescue is possible. If necessary the Board will then be able to assume responsibility for that scheme in the normal way.

7.4 These regulations outline the form and content of the various applications and notices which must be issued by insolvency practitioners, pension scheme trustees, The Pensions Regulator and the Board throughout the assessment period.

7.5 These regulations provide a list of additional insolvency events which are not already covered in section 121 of the Act. These will enable the pension schemes of employers such as building societies and limited liability partnerships to start an assessment period should the sponsoring employer suffer an insolvency event which is not defined in the primary legislation.

7.6 These regulations provide for the prescribed requirements which an employer must meet for section 129 application purposes. They enable the trustees or managers of a pension scheme which is sponsored by either a public body or an unincorporated charity to apply to the Board under section 129 if they become aware that the sponsoring employer is no longer continuing as a going concern. They further provide for The Pensions Regulator to issue a notice to this effect if they become aware of the situation before the scheme trustees. These regulations are necessary as it is not possible for either a public body or an unincorporated charity to have an insolvency event as defined in the Act.

7.7 These regulations provide the criteria the insolvency practitioner must use to determine whether a scheme rescue has occurred, a scheme rescue is not possible, or it is not possible for him to determine either way. In the circumstances where the employer is a public body or an unincorporated charity and there is no insolvency practitioner appointed these regulations further provide the criteria the Board must

use to determine whether a scheme rescue has occurred or a scheme rescue is not possible.

7.8 There are a number of restrictions placed on trustees during an assessment period. These regulations provide for the circumstances where these restrictions do not apply. For example they provide that contributions can be paid towards a scheme where those contributions related to any part of the employer's liability to pay a debt to the scheme under section 75 of the Pensions Act 1995. They further provide the circumstances where the trustees may discharge their liability to pay a pension or benefit in respect of a member during the assessment period.

7.9 These regulations provide that the Board may issue directions to the scheme administrator responsible for the discharge of functions under Part 4 of the Finance Act 2004. This is necessary as these administrators have a statutory responsibility which is different to the trustees of a pension scheme.

7.10 These regulations provide that if there is still a possibility the scheme may be rescued a member may choose to postpone their pension during the assessment period. If a person becomes entitled to a death in service benefit due to an active member dying before the start of an assessment period these regulations provide for this benefit to be treated as becoming payable before the start of the assessment period.

7.11 These regulations provide the rate of interest which must be charged on any loan granted by the PPF to pension scheme trustees during an assessment period. This is the market rate of interest and will enable the PPF to recoup any money it would have made had the money instead remained in the PPF bank account.

7.12 These regulations provide that when an assessment period ends in relation to a scheme because it has been rescued, that any active members of the scheme may backdate their pensionable service for the time the scheme was in the assessment period on condition that they pay their corresponding contributions to the scheme within a set time. The regulations further provide that when a member chooses to exercise his right to do this the employer must also pay his contributions in relation to this member.

7.13 These regulations provide that where the Board finds that if at any point a scheme was not an eligible scheme or that a new scheme was created to replace an existing scheme during the three year period prior to the assessment date it must refuse to assume responsibility for that scheme. These regulations are intended to safeguard against moral hazard – where the trustees of a scheme realise that the employer is at risk of going insolvent and the pension scheme is underfunded they might attempt to make the scheme eligible or replace the scheme with a new one in order that the PPF would take on the scheme's liabilities.

7.14 These regulations provide the form and content of the audited scheme accounts which must accompany any application by the scheme trustees for the Board to reconsider assuming responsibility for the scheme. These regulations mirror The Occupational Pension Schemes (Requirement to Obtain Audited Accounts and a Statement from the Auditor) Regulations 1996 which provides for annual audited scheme accounts.

7.15 Consultation has not taken place for these regulations. As these Regulations are made before the expiry of the period of six months beginning with the coming into force of the provisions of the Act by virtue of which they are made, the requirement for the Secretary of State to consult such persons as he considers appropriate does not apply.

8. Impact

8.1 An assessment of the compliance costs to business of the measures arising from the Act, including these Regulations, has been placed in the libraries of both Houses of Parliament. Copies may be obtained from the Department for Work and Pensions, Regulatory Impact Unit, 3rd Floor, The Adelphi, 1-11 John Adam Street, London WC2N 6HT. This is also available at http://www.dwp.gov.uk/publications/dwp/2004/ria/pensions_bill_2004_rev.pdf. The relevant paragraphs of the RIA are attached to this memorandum.

8.2 As debates in both houses made clear, some public sector defined benefit pension schemes will be required to pay the Pension Protection Levies. This Statutory Instrument sets out the criteria for a scheme to be an eligible scheme, therefore there will be a minimal impact on the public sector arising from these regulations.

9. Contact

Hannah Malik at the Department for Work and Pensions Tel: 020 7962 8400 or e-mail: hannah.malik@dwp.gsi.gov.uk can answer any queries regarding the instrument.

3.2 The Pension Protection Fund

3.2.1 The Bill introduces a compensation scheme for private sector DB and hybrid[6] occupational pension schemes in the UK, run by a statutory body known as the Pension Protection Fund (PPF). Where the sponsoring employer has become insolvent, and the pension scheme has insufficient assets to cover the PPF level of benefits by means of annuity purchase, the PPF will take over the assets of the scheme and pay compensation to scheme members. The risk of doing nothing is that individuals whose employer becomes insolvent can end up with only a fraction of the pension that they expected. The PPF will in general compensate to 100% of the amount of pension in payment (or accrued) for people over the scheme's normal pension age (as well as survivors and ill-health pensioners), and 90% of the accrued level of pension entitlement for people under normal pension age.

Miss Garnett has a deferred pension in a scheme where the employer fails

5 Hybrid schemes can take a large variety of forms, but all include both defined benefit and defined contribution elements

> Miss Garnett is aged 42 and has a preserved pension in a scheme following redundancy a couple of years ago. The preserved pension is £2,500 a year, based on 20 years' service and final earnings of £9,000, plus a little revaluation. She worked for a small engineering firm based in the North West of England. The firm is close to insolvency.
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> If the company did become insolvent, the pension scheme would have liabilities of £2.2 million and assets of £1.3 million. The liabilities of pensioners account for £0.65 million. Pensioners would be paid in full, leaving assets of £0.65 million and liabilities of £1.55 million for non-pensioners.
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> This means that working age members of the scheme would receive only around 42% of the value of their accrued rights on the MFR basis. In the case of Miss Garnett, this amounts to a transfer value which would generally produce a pension of less than 42% of her accrued rights – that is, less than £1,050 a year. The investment risk over the period to retirement means that the pension could be substantially lower. Alternatively if a guaranteed deferred annuity were bought with the transfer value the amount of the pension secured might be as little as £600 per year.
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> If the PPF had existed to guarantee Miss Garnett's pension at 90%, she would have had a guaranteed pension of £2,250 per year, £1,200 per year more than the pension supposedly provided by her MFR based transfer value, and over £1,600 per year greater than that which could be secured by the purchase of a deferred annuity. The PPF could have more than tripled her income devised from occupational pension rights in retirement.

3.2.2 The compensation scheme will be funded by a levy on those schemes providing defined benefit pension provisions and DB elements of hybrid schemes. The responsibility for payment of the levies rests with the scheme trustees or managers. However we expect, in practice, that sponsoring employers will bear the brunt of the costs of the levies.

3.2.3 The Bill requires at least 50% of the levy to be based on the level of scheme underfunding relative to the costs of securing the PPF level of compensation and other possible risk factors, such as the risk of sponsor insolvency and the investments of the scheme relative to its liabilities. The remainder of the levy should be assessed with reference to scheme factors such as the number of members or the amount of the liability. However for practical reasons it will not be possible for this to be in place immediately when the PPF starts. There will therefore be an initial levy (the first levy) set by the Secretary of State and a further transitional period when modifications may be made to the provisions governing the PPF Board's setting the levy in the light of practical considerations.

3.2.4 The following table illustrates a very simplified structure for the levy based only on allowing for underfunding (relative to securing the PPF level of compensation as a risk factor). It is intended that when the PPF is able to implement the levy procedures in full it will include other risk factors. This is based on the assumption that the total levy would be about £300 million, with 80% of the total derived from a risk-factor based levy.

Funding level relative to PPF level of compensation	Levy/Premium
Over 100% funded	Scheme factor levy only
Between 80% and 100% funded	Scheme factor rate levy; risk-based levy of £4 per £1,000 of under-funding
Under 80% funded	Scheme factor levy; risk-based levy of £4 per £1,000 of under-funding for first 20% of under-funding, plus £8 per £1,000 of under-funding for rest of the under-funding.

3.2.5 On this basis, and assuming that there was a levy of £4 per member (including active, deferred and pensioner members), the amount of levy for three specimen schemes is shown in the following table.

	Scheme A	Scheme B	Scheme C
Number of Members	1,000	20,000	50,000
Assets	£30 million	£900 million	£2,000 million
PPF benefit Liability	£40 million	£1,000 million	£2,500 million
Underfunding	£10 million (75%)	£100 million	£400 million (80%)
Scheme factor levy	£4,000	£0.08 million	£0.2 million
Risk Factor based levy	£48,000	£0.4 million	£1.6 million
Total levy	£52,000	£0.48 million	£1.8 million

Summary of options and impact of consultation

3.2.6 An alternative option which was considered was a "central clearing house" which would take in the assets of pension schemes and purchase annuities on behalf of members (deferred in the case of those under retirement age), but it would not top up those assets. This was rejected because it would still leave members at risk of losing all or most of their pension. Of the respondents who commented on the proposal to introduce an insurance scheme, 53% agreed with some form of insurance, 28% were neutral and 19% were not in favour at all. Of the respondents who commented on the option of a "centralised clearing house", 35% were in favour of the proposal and 29% disagreed.

3.2.7 Also considered was whether the assets of a scheme whose sponsor is insolvent should be topped up to the level needed to insure the scheme benefits, or some specified lower level of benefits, on winding up. As with the PPF, a levy would have been needed to meet the costs. This was rejected in favour of the PPF where instead of insuring the benefits, the PPF will operate in a manner similar to a pension scheme, by paying the amount of compensation as they payments become due. The PPF approach was considered to provide a more stable approach to the meeting the costs of any underfunding by being better able to smooth the levy over time.

Costs including Savings and Benefits

3.2.8 The costs across all employers with DB pension schemes will be approximately £300 million a year, depending on the level of the guarantee opted for. This is based on the assumption that 90% of a pension for a member below normal pension age will be protected, up to a maximum of £25,000 a year, with 100% of the pension in payment guaranteed for pensioners over the scheme normal pension age and for survivors and ill-health pensions in payment. The amounts of pension which have accrued to members since April 1997 will be indexed in line with changes to the retail price index subject to a maximum of 2.5% a year. In order to meet the running costs of the PPF, a separate flat-rate administration levy will be introduced. This is estimated to incur a cost of £15 million a year across all schemes.

Impact on different business sectors

3.2.9 There is no reason to believe that different business sectors will be affected in different ways. This proposal will only affect private sector DB schemes. The intention is to minimise the impact on small businesses. Schemes with fewer than 100 members will be subject to a simpler approach to determining the levy in order to reduce the administration costs to them.

Securing compliance

3.2.10 The requirement to pay the PPF levy will be set out in legislation. Failure to make relevant payments will be sanctionable by The Pensions Regulator.

3.3 Improved compensation arrangements

3.3.1 A Compensation Scheme was established by the 1995 Pensions Act to compensate schemes, where the employer is insolvent, for loss caused by dishonesty. It is operated by the Pensions Compensation Board and financed by a levy paid by occupational pension schemes.

3.3.2 There are currently restrictions on the maximum amount of compensation which can be paid. For DB schemes, legislation restricts the amount of compensation which can be paid to the amount needed to bring the value of the scheme's assets up to 100% of its liabilities for pensioners and members within ten years of retirement, and 90% of its liabilities for other members (calculated using the valuation methodology for the MFR) or, if lower, the amount of the actual loss. For DC schemes, compensation is limited to 90% of the loss.

3.3.3 It is proposed to enhance the current arrangements to remove these restrictions, and ensure that schemes with an insolvent employer can be compensated for the full amount lost as a result of acts of dishonesty.

3.3.4 If the proposed change were not implemented, the security of the pension rights built up by members of schemes that suffer from acts of dishonesty would continue to be at risk.

Summary of options

3.3.5 For DB schemes, the method of calculating the amount of compensation payable is currently linked to the MFR. Since the Government proposes to replace the MFR with scheme-specific funding requirements, continuing with the current arrangements is not an option.

3.3.6 The Government considered limiting the compensation payable in the case of a DB scheme to the amount needed to restore it to full funding on the basis of the scheme-specific approach it adopted after the MFR is replaced. This was ruled out because it could give rise to inconsistencies in the amounts of compensation payable. The Government also considered enabling the Pensions Compensation Board to have discretion to pay a lower amount of compensation than the actual loss, but this would increase complexity, and could lead to allegations of unfairness.

3.3.7 In March 2001, the Government published *Security for occupational pensions: The Government's proposals*, which set out the Government's proposals for replacing the MFR. It also included proposals for enhancing the compensation scheme. Most of the respondents who expressed an opinion on the proposals agreed with them, although some expressed concerns about potential increase in costs for well- run schemes.

3.3.8 The proposal to allow schemes where the sponsoring employer is insolvent to be compensated for the full amount lost as a result of acts of dishonesty would be simple to operate, transparent and should not have a disproportionate impact on any particular business sector.

Costs including Savings and Benefits

3.3.9 It is estimated that the increase in the total amount that would need to be raised by the levy across all schemes will be of the order of £10,000 a year. However, the estimate must be regarded with caution, since it is based on the very small number of cases which have come to light in the short time the scheme has been in operation (compensation has only been paid in a few cases). There is no other available information on which to base an estimate, but the figure would clearly be substantially increased in the event of a large scale fraud.