EXPLANATORY MEMORANDUM TO THE

OCCUPATIONAL PENSION SCHEMES (LEVIES) REGULATIONS 2005

2005 No.842

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 is a body corporate established by section 107 of the Pensions Act 2004 (c.35) ("the Act"). The PPF Ombudsman is a commissioner established by section 209(1) of the Act.

2.2 This instrument provides for trustees or managers of eligible occupational pension schemes (as defined in section 126 of the Act) to pay an administration levy in 2005-6 to the Secretary of State for Work and Pensions, as provided for in section 117 of the Act. The instrument sets out how the levy amount varies for schemes of different sizes. It also provides for trustees or managers of eligible schemes to pay a PPF Ombudsman levy to the Secretary of State, as provided for in section 209 of the Act. However that levy is not payable for 2005-6 (because of the small sums likely to be needed that year).

2.3 This instrument further provides for trustees or managers of eligible schemes to pay the initial levy to the Board, as provided for in section 174 of the Act. The instrument sets out how the initial levy is to be calculated and the period over which it will apply.

2.4 The instrument also makes provision for multi-employer schemes[1], hybrid schemes[2] and partially guaranteed schemes[3], and for avoidance of double liability for schemes in Northern Ireland.

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

2 "Hybrid scheme" is defined in section 307(4) of the Act, and means an occupational pension scheme
- (a) which is not a money purchase scheme, but
- (b) where some of the benefits that may be provided are –
  - (i) money purchase benefits attributable to voluntary contributions of the members, or
  - (ii) other money purchase benefits.

3 "Partially guaranteed scheme" means an eligible scheme (defined in section 126 of the Act) in respect of which a relevant public authority (as defined in section 307(4) of the Act) has –

- (a) given a guarantee in relation to any part of the scheme, any benefits payable under the scheme rules or any members of the scheme, or

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

3.1 These draft Regulations are made under powers in the Act and are subject to the affirmative procedure. The use of the affirmative procedure is required by section 316(2) of the Act.

3.2 These draft Regulations are being issued free of charge to all known recipients of the earlier draft Regulations which were laid before Parliament on 2nd February 2005 and withdrawn on 7th February 2005.

3.3 A new regulation 17 has been inserted into the draft Regulations to provide for how the draft Regulations apply in relation to hybrid schemes. Regulation 10 has been amended as a consequence, with corresponding consequential amendments of regulations 2 and 11.

4. Legislative Background

4.1 The Act received Royal Assent on 18 November 2004. Section 107 establishes the Board of the PPF ("the Board"). The Board is an executive non departmental public body, at arms' length from Government, which will pay compensation to members of eligible pension schemes when the employer is insolvent and the pension scheme is underfunded.

4.2 Section 117 of the Act provides for the imposition of an administration levy in respect of eligible schemes, to meet:

- Expenditure of the Secretary of State relating to the establishment of the Board
- Any expenditure of the Secretary of State which the Secretary of State pays the Board towards its expenses out of money provided by Parliament (through Grant in Aid).

4.3 Section 126 of the Act makes provision about which occupational pension schemes are eligible schemes.

4.4 Section 174 of the Act provides for regulations to impose an initial levy on eligible schemes, with the approval of the Treasury.

4.5 The Act establishes the office of PPF Ombudsman, appointed by the Secretary of State for Work and Pensions. Sections 213 and 214 provide for the PPF Ombudsman to investigate and determine references of "reviewable matters" and complaints of maladministration. Section 209(7) provides for regulations to impose a levy on eligible schemes.

4.6 This is the first use of these Regulation making powers under the Act.

(b) made any other arrangements for the purposes of securing that the assets of the scheme are sufficient to meet any part of its liabilities.

5. Extent

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

6.1 In the view of Malcolm Wicks MP, the Minister of State for Pensions, the provisions of the Regulations are compatible with the Convention rights.

7. Policy background

7.1 The administrative costs of the PPF Board are to be kept entirely separate from the Pension Protection Fund which the Board manages. The levy on eligible schemes means that they, rather than the general taxpayer, will fund the Board's administration costs. The administration levy covers expenditure by the Secretary of State in establishing the Board, and will recoup money provided by Parliament through Grant in Aid towards the expenses of the Board.

7.2 Payment of compensation by the PPF Board will be funded by levies on eligible schemes and the assets of schemes for which the Board is required to assume responsibility. Between 6th April 2005 and 31st March 2006 an initial levy – as provided for by these regulations – will be imposed on eligible schemes and the unsecured part of eligible schemes which are partially guaranteed. However, the levies will not be imposed in respect of any part relating only to money purchase benefits of an eligible hybrid scheme. (It is this provision which was omitted from the earlier draft of this Statutory Instrument which was laid before Parliament on 2nd February 2005 and withdrawn on 7th February 2005.) Hybrid schemes are schemes which have a money purchase (defined contribution) element and a defined benefit (salary related) element. The PPF is designed to apply to defined benefit schemes only; for this reason the provisions will apply to hybrid schemes only in respect of any defined benefit element. In subsequent years the PPF Board will set Pension Protection levies in accordance with sections 175 to 181 of the Pensions Act 2004.

7.3 Section 174 of the Pensions Act provides for the charging of an initial levy by the Board to all eligible pension schemes. The initial levy will be charged on a per member basis, with a lower rate for deferred members than for active and pensioner members.

7.4 Where a scheme ceases to be eligible part way through a financial year no refund of the levies paid in respect of that financial year will be

made. This policy is necessary in order to avoid undue administrative complications, and is in line with Opra's current provisions for the general levy. Collection of the levy is to be outsourced; for this reason the Board must be able to accurately predict the administrative duties involved in levy collection which could not be done if refunds were to be given part way through a levy year. More importantly, the Board of the PPF will need be able accurately to determine the amount it will raise through the levies for the beginning of each financial year, in order that the PPF can cover its liabilities each year. In addition, it is very unlikely that a pension scheme would cease to be an eligible scheme part way through a year.

7.5 Section 213 of the Pensions Act provides for review and reconsideration by the Board of the reviewable matters listed in Schedule 9. The Board may undertake a review/reconsideration either in response to an application for a review or of its own volition. Section 214 of the Pensions Act also provides for investigation by the Board of complaints concerning maladministration. If either type of dispute remains unresolved, the reviewable matter or the maladministration complaint may be referred to the PPF Ombudsman.

7.6 The costs of the PPF Ombudsman are initially paid by the Secretary of State via Grant in Aid, but will be recouped via the PPF Ombudsman levy, so that the costs fall on eligible pension schemes with access to his office, rather than by the general taxpayer.

8. Impact

8.1 An assessment of the impact on business, charities or the voluntary sector of the provisions in these Regulations for the administration levy, the initial levy and the pension protection levy was included in the Regulatory Impact Assessment that accompanied the Pensions Act 2004. A copy of that assessment 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, level 3, Adelphi, 1-11 John Adam Street, London WC2N 6HT. The relevant extract is enclosed.

8.2 The provisions in these regulations for the PPF Ombudsman levy will have no cost impact in 2005-6 and only a negligible future cost impact on business, charities or the voluntary sector. Publication of a full Regulatory Impact Assessment is not necessary for such legislation.

9. Contact

Sarah Ormerod at the Department for Work and Pensions Tel: 020 7712 2757 or e-mail: sarah.ormerod@dwp.gsi.gov.uk can answer any queries regarding the instrument.

9 February 2005

Extract from the Pensions Bill Regulatory Impact Assessment

3.2 The Pension Protection Fund

3.2.1 The Bill introduces a compensation scheme for private sector DB and hybrid 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.
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.

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.

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.

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.

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the Secretary of State for Work and Pensions, Andrew Smith

Andrew Smith……………………………………………….

Date …8 June 2004………………………………………….

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