

**EXPLANATORY MEMORANDUM TO**  
**THE PENSION PROTECTION FUND (PENSION COMPENSATION CAP)**  
**ORDER 2006**

**2006 No.347**

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

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. **Description**

- 2.1 This Order sets out the level of the compensation cap for the Pension Protection Fund which has been reviewed in line with the increase in the level of average earnings in the 04/05 tax year and is applicable from 1<sup>st</sup> April 2006.

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

**Use of Affirmative procedure**

- 3.1 This order is made under powers in the Pensions Act 2004 and is subject to the affirmative procedure.
- 3.2 The use of the affirmative procedure is required by section 316 (2)(s) (Parliamentary control of subordinate legislation) of the Pensions Act 2004.

4. **Legislative Background**

- 4.1 The compensation cap was introduced from 6<sup>th</sup> April 2005 when the PPF came into being. The level of the cap was set at that time in consultation with HM Treasury taking into account available figures for 2003/2004 on average earnings and pension income.
- 4.2 The provision of a compensation cap is one of a number of measures introduced to limit the level of expenditure of the Pension Protection Fund against the level of income generated by way of the levies charged to eligible schemes.
- 4.3 The level of the compensation cap has been set to encourage scheme members, in particular those with high earnings, to become more involved in scheme matters and help reduce the risk of the scheme entering the Pension Protection Fund.

- 4.4 To achieve this, the level of compensation payable by the Board to members who are below their scheme's normal pension age is limited to 90% of the compensation cap if the value of the pension that they would have received exceeds the amount of compensation cap.
- 4.5 The current compensation cap is £27,777.78. In calculating a member's compensation entitlement the cap is applied before compensation is reduced to the 90% level. This provides that the total value of compensation payments for members below normal pension age does not exceed the equivalent of £25,000 per year at age 65. This amount is adjusted depending on age to ensure that the actuarial value of the compensation package remains the same.
- 4.6 Average earnings, as measured by the Average Earnings Index and published by the Office for National Statistics, increased by 4.2% in the 04/05 tax year. The amount of the compensation cap set in April 2005 has been increased from April 2006 applying the 4.2% increase in average earnings and is £28,944.45. When applying the 90% provision to this updated cap this provides, at age 65, a maximum level of compensation of £26,050.01.
- 4.7 The powers in paragraph 27 (Increasing the cap in line with earnings) and paragraph 26(7) (Compensation Cap) of Schedule 7 provide that the Secretary of State must increase the amount of the compensation cap from 1<sup>st</sup> April each year where a review of the general level of earnings shows an increase over the previous tax year.
- 4.8 Article 2 of this Order specifies that the amount of the compensation cap for the purposes of paragraph 26 of Schedule 7 to the Pensions Act 2004 be increased in line with the increase in average earnings for the 2004/02005 tax year and shall be £28,944.45 from 1<sup>st</sup> April 2006.
- 4.9 This instrument is the first use of the power in the Pensions Act 2004 to bring about an annual increase in the level of the compensation cap in line with an increase in the general level of earnings.

## **5. Extent**

- 5.1 This instrument applies to Great Britain.

## **6. European Convention on Human Rights**

Stephen Timms, The Minister of State for Pensions Reform has made the following statement regarding Human Rights:

In my view the provisions of the Pension Protection Fund (Pension Compensation Cap) Order 2006 are compatible with the Convention rights.

## **7. Policy background**

- 7.1 The Pension Protection Fund has been set up to provide a statutory form of compensation for members of defined benefit occupational pension schemes, where the employer has a qualifying insolvent event and the assets in the scheme would not provide pension at Pension Protection Fund compensation levels.
- 7.2 An annual levy likened to an insurance provision is applied to all qualifying defined benefit occupational pension schemes and is paid into the Pension Protection Fund. In addition a risk assessed levy is also payable by those schemes which are considered most likely to enter the Pension Protection Fund at some point in the future.
- 7.3 Where an insolvency event occurs the scheme enters an assessment period during which time the trustees or managers are required to provide payment to members at least at Pension Protection Fund compensation levels.
- 7.4 At the end of that assessment period if a valuation shows that the scheme has assets below the level required to provide pensions at least equal to Pension Protection Fund compensation payments and a scheme rescue is not possible the Board of the Pension Protection Fund assumes responsibility for the scheme.
- 7.5 All assets, responsibilities and liabilities of the scheme transfer to the Pension Protection Fund and the trustees or managers are discharged of their responsibilities towards the scheme.
- 7.6 The Board is then responsible for providing compensation payments out of the Pension Protection Fund, to the members of those schemes which have transferred in, in accordance with compensation provisions.
- 7.7 There is no formal requirement to consult on an Order made by the Secretary of State. DWP are only required to consult SSAC on Regulations which have an impact on DWP benefits.

## **8. Impact**

- 8.1 A Regulatory Impact Assessment has not been prepared for this instrument as it has no impact on business, charities or voluntary bodies.
- 8.2 There is no impact on the public sector.

## **9. Contact**

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