SPOTLIGHT ON THE PENSION PROTECTION FUND FOR DB SCHEMES

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Concerns about the strength of defined benefit (DB) schemes can be a trigger for considering transfers into defined contribution (DC) schemes, particularly for high earners potentially affected by the Pension Protection Fund (PPF) compensation cap. So it's useful for advisers to have an understanding of how the PPF works.

THE PATH TO THE PPF

The PPF was set up under Pensions Act 2004 and its protection applies from 6 April 2005 to members of DB schemes where a sponsoring employer becomes insolvent and the scheme has insufficient assets to pay the compensation the PPF would provide. The PPF isn't state-backed or taxpayer funded, instead it's funded by levies on eligible pension schemes and its own investments relating to schemes it's taken on.

Member protection actually starts with The Pensions Regulator, which works with trustees and sponsoring employers on recovery plans for DB schemes in deficit. However, if a DB scheme is in deficit when its sponsoring employer goes into liquidation, it's unlikely to be able to meet its pension promises. At this point the scheme enters PPF assessment, which normally lasts up to two years.

During assessment, the scheme trustees remain responsible for member payments adjusted in line with PPF rules. It's not normally possible to transfer during assessment or once the PPF has taken on a scheme and transfer values are restricted even where a member does meets the strict criteria. The PPF doesn't cover DC benefits, so where relevant it provides alternative options for affected members.

PPF assessment has three possible outcomes:

- A new employer rescues the scheme, possibly following restructuring agreed with The Pensions Regulator.
- The scheme has enough assets to secure benefits with an insurance company at or above PPF compensation levels.
- The PPF takes on the scheme.

PPF COMPENSATION

The level of PPF compensation depends on a member's status at the date their scheme enters PPF assessment. The amount is based on their existing entitlement at the assessment date, possibly adjusted to take account of the scheme's admissible rules and for GMP equalisation. Admissible rules set aside most non-statutory rule changes and discretionary increases made in the three years before a scheme enters PPF assessment, and also rules that come into effect on an employer's insolvency.

PPF compensation is taxable. Members can normally commute up to 25% of their PPF compensation for tax free cash, subject to the usual rules. It's also possible to commute compensation for a PPF severe ill health lump sum, and under the trivial commutation or winding up lump sum rules.

90% capped compensation
As at PPF assessment date: • Active member below scheme's normal pension age (NPA). • Deferred member below NPA. • Member receiving pension below NPA (apart from legitimate ill-health early retirement). • Pension credit member below normal benefit age (NBA).

100% compensation
As at PPF assessment date: • Member in active service above NPA not receiving pension. • Postponed member above NPA. • Member or pension credit member receiving pension above NPA/NBA. • Member receiving pension below NPA following legitimate ill-health early retirement. • Existing survivors' pensions.

90% CAPPED COMPENSATION

- **Active member below NPA at PPF assessment date**
- **Deferred member below NPA at PPF assessment date**

PPF compensation is payable from NPA at 90% of the member's pension entitlement under the scheme's admissible rules at the PPF assessment date and is subject to the compensation cap. It's normally possible to commute up to 25% for tax free cash if there's no separate lump sum entitlement. Commutation uses PPF factors, taking into account the member's exact age, pre and post 1997 accrual and any spouse's pension.

Deferred members get revaluation at scheme rates between their active membership ceasing and the scheme entering PPF assessment. PPF compensation is revalued between the assessment date and NPA, or taking benefits if earlier. For schemes entering PPF assessment from 31 March 2011, revaluation is at CPI capped at 5% for benefits relating to pensionable service up to 5 April 2009; and CPI capped at 2.5% for pensionable service from 6 April 2009. There's no PPF revaluation if the scheme's admissible rules make no provision for this. Special provisions apply to career average revalued earnings schemes.

The compensation cap applies at NPA, or taking benefits if earlier. Early payment is possible from normal minimum pension age (currently 55), or from age 50 with a protected pension age. Members can normally postpone payment up to age 75, in which case revaluation ceases at NPA. The PPF uses its own actuarial adjustments for early or late payment.

Once in payment, PPF compensation attributable to pensionable service from 6 April 1997 only is indexed at CPI capped at 2.5%. Different rates can apply to schemes that entered PPF assessment before 1 January 2012.

Active employee, not affected by compensation cap

In all the examples, we'll assume a DB scheme entered PPF assessment on 1 May 2016. For simplicity, there were no benefit adjustments as a result of moving to admissible rules or from GMP equalisation. The key provisions immediately before the PPF assessment date were:

- Normal pension age: 62.
- Benefit accrual: n/60ths.
- Tax free cash by commutation.
- Indexation at RPI capped at 5% for both pre and post 1997 accrual.

Harry was an active employee member aged 60, with 18 years pensionable service and pensionable salary of £80,500 as at 1 May 2016. He'll take his PPF compensation at NPA of 62.

- Accrued benefits under admissible rules: 18/60 x £80,500 = £24,150.
- Revalued under PPF rules to NPA at age 62: £24,635 (assumed).
- Compensation cap at age 62 (assuming no change since 1 April 2017): £34,873.00.*
- PPF compensation £24,635 x 90% = £22,171.50 a year, indexed at CPI capped at 2.5% for post 1997 service only.
- Harry can commute up to 25% of his £22,171.50 compensation for tax free cash.

Harry will receive 90% of his expected benefits at NPA and is likely to get lower increases than his scheme would have provided.

Active employee, compensation cap applies

Ginny was also an active employee member aged 60 on 1 May 2016. She had 18 years pensionable service and pensionable salary of £162,000. She'll also take her PPF compensation at NPA.

- Accrued benefits under admissible rules: 18/60 x £162,000 = £48,600.
- Revalued under PPF rules to NPA at age 62: £49,577 (assumed).
- Compensation cap at age 62 (assuming no change since 1 April 2017): £34,873.00, so her entitlement is capped.*
- Cap fraction: cap/pre-commutation pension = £34,873 / £49,577 = 0.7034109.
- Cap for annual rate of pension: 0.7034109 x £49,577 = £34,873.
- PPF compensation: £34,873 x 90% = £31,385.70 a year, indexed at CPI capped at 2.5% for post 1997 service only.
- Ginny can commute up to 25% of her £31,385.70 compensation for tax free cash.

Ginny will receive around 63% of her expected benefits at NPA and is likely to get reduced increases.

*Subject to Parliamentary approval at the time of writing.

- **Member receiving pension below NPA (not legitimate ill-health early retirement) at PPF assessment date**

PPF compensation is payable immediately at 90% of the member's pension entitlement under admissible rules at the assessment date and is subject to the compensation cap, taking account of any tax free cash already received.

Early retirement, still below NPA
Neville was a pensioner aged 57 on the PPF assessment date of 1 May 2016, having retired early shortly before this. This wasn't on ill health grounds. His early retirement options were a pension of £48,000 a year indexed by RPI capped at 5%, or £205,700 tax free cash and a reduced pension of £30,858 a year. He'd taken the reduced pension plus tax free cash. He had less than 20 years pensionable service. • Pension in payment just before PPF assessment date: £30,858 a year indexed at RPI capped at 5%. • Compensation cap at age 57 from 1 April 2016: £29,824.31. Ie cap applicable as at 1 May 2016. • Cap fraction: £29,824.31 (cap) / £48,000 (pre-commutation pension) = 0.6213398. • Cap for annual rate of pension: 0.6213398 x £30,858 (post-commutation pension) = £19,173.30. • 90% of capped compensation: £19,173.30 x 90% = £17,255.97 a year, indexed at CPI capped at 2.5% for post 1997 service only. As an early retiree, Neville gets an immediate 44% cut in his pension income and is likely to get reduced increases.

- **Pension credit member below NBA at PPF assessment date**

PPF compensation is payable from NBA at 90% of the member's entitlement under admissible rules at the assessment date and is subject to the compensation cap. It's normally possible to commute 25% for tax free cash if there's no separate lump sum entitlement. Pension credit members don't benefit from revaluation and don't normally have the right to payment earlier or later than NBA.

100% COMPENSATION

- **Member in active service above NPA not receiving pension at PPF assessment date**
- **Postponed member above NPA at PPF assessment date**

PPF compensation is payable immediately at 100% of the member's pension entitlement under admissible rules at the assessment date, including any scheme increases for deferral since NPA. It's normally possible to commute 25% for tax free cash if there's no separate lump sum entitlement. It's normally also possible to further postpone payment of PPF compensation up to age 75 in exchange for an actuarial increase.

Active employee member, over NPA
Hermione was an active employee member aged 64 on 1 May 2016. At NPA she had 24 years pensionable service and pensionable salary of £162,000. • Accrued benefits under admissible rules: 24/60 x £162,000 = £64,800 uplifted to £68,040 as at 1 May 2016 using the scheme's late retirement rules. • As Hermione is over NPA, the compensation cap doesn't apply. • PPF compensation payable from assessment date: £68,040 x 100% = £68,040 a year, indexed at CPI capped at 2.5% for post 1997 service only. • Hermione can also commute up to 25% of her £68,040 compensation for tax free cash. Hermione can take her benefits immediately or postpone them. While there's no immediate cut in her expected benefits, she's likely to get reduced increases.

- **Member or pension credit member receiving pension above NPA/NBA at PPF assessment date**
- **Member receiving pension below NPA following legitimate ill-health early retirement at PPF assessment date**
- **Existing survivor's pensions at PPF assessment date**

PPF compensation is payable immediately at 100% of the pension payable under admissible rules at the assessment date. This also applies if someone is conditionally entitled to a survivor's pension under the scheme rules at the assessment date and first meets the relevant condition(s) afterwards.

Pensioner over NPA
Lily was aged 82 and receiving a member's pension when the scheme entered PPF assessment. All her pensionable service was pre 1997. • Pension in payment just before 1 May 2016: £8,300 indexed at RPI capped at 5%. • Compensation: 100% x £8,300, no indexation. There's no immediate cut in Lily's pension, but she'll lose out over time by not receiving any increases.

Pensioner under NPA, legitimate ill health early retirement
Ron was aged 57 and receiving an ill health early retirement pension when the scheme entered PPF assessment. He had significant pre 1997 benefit accrual. • Pension in payment just before 1 May 2016: £75,000 indexed at RPI capped at 5%. • Compensation: £75,000 x 100% = £75,000, indexed at CPI capped at 2.5% for post 6 April 1997 accrual only. Even though Ron is under NPA, there's no immediate cut in his pension, but his future increases are likely to lower than previously expected.

COMPENSATION CAP

PPF compensation is capped for members aged below NPA/NBA at the date their scheme enters PPF assessment, apart from those receiving legitimate ill health early retirement pensions. Affected members are entitled to a maximum of 90% of the capped compensation.

The compensation cap normally increases each year in line with average earnings. Regulations set the compensation cap at age 65, while the PPF publishes actuarial tables for other ages. For example, from 1 April 2017, the compensation cap is £38,505.61 at age 65. Subject to Parliamentary approval, it's £32,769.97 at age 60 and £28,427.32 at age 60. So the maximum compensation at age 65 is currently £34,655.05 a year for those with up to 20 years pensionable service, before any commutation for tax free cash.

Pension benefits are first calculated under the scheme's admissible rules at the PPF assessment date. Where relevant, revaluation applies up to NPA/NBA or taking benefits if earlier. The compensation cap applies to the revalued compensation at NPA/NBA, or the date the member takes benefits if earlier. Deferring compensation doesn't increase the chance of the cap applying.

LONG SERVICE CAP

The Government announced in September 2016 that a long service cap will apply from April 2017. The standard cap will increase by 3% for every year of pension scheme membership in excess of 20 years.

At the time of writing, the required regulations are not yet in force, although the associated consultation completed in November 2016.

DEATH BENEFITS

Any life assurance cover providing a lump sum under the pension scheme ceases from the PPF assessment date.

The PPF can pay 50% survivor's pensions to spouses, civil partners or cohabitees ('relevant partners' in PPF terminology), provided they were also eligible under the scheme rules. If the member dies below NPA/NBA, death benefits are 50% of the compensation they would have received if they'd reached their NPA/NBA at the date of death. On death above NPA/NBA, it's 50% of the compensation the member was receiving at the date of death.

The PPF pays pensions to dependent children under age 18, or over 18 and under 23 in full time education or with a qualifying disability. During the assessment period this is subject to eligibility under the scheme rules. The amount depends on the number of children and whether or not compensation is also payable to a surviving spouse, civil partner or cohabitee.

DIVORCE

The PPF takes any existing pension sharing and earmarking orders into account, including any orders made but not implemented by the scheme before it goes into PPF assessment. If someone gets divorced after the PPF takes on a scheme, compensation sharing and earmarking orders are available, but a credit recipient can't take a cash equivalent transfer value to their own choice of scheme.

ILL HEALTH

PPF compensation doesn't include ill health early retirement, although anyone over age 55 has the option of taking their PPF compensation early with the normal PPF actuarial reduction.

A PPF terminal ill health lump sum is available for members with life expectancy of six months or less, provided they're under NPA/NBA and haven't already claimed their PPF compensation. The lump sum is equivalent to two years' payments with no early retirement reduction. If they survive longer than two years, they can't claim any further compensation. The normal PPF death benefits remain available.

HAMPSHIRE V PENSION PROTECTION FUND

Mr Hampshire is a member of the PPF. His expected pension benefits as a long-standing member of the T & N Retirement Benefits Scheme were significantly reduced by the compensation cap, to an extent which he argues is incompatible with EU law. In its July 2016 provisional judgement, the Appeal Court referred the matter to the Court of Justice of the European Union (CJEU). Any further developments may take a considerable time.

Every care has been taken to ensure that this information is correct and in accordance with our understanding of the law and HM Revenue & Customs practice, which may change.
However, independent confirmation should be obtained before acting or refraining from acting in reliance upon the information given.
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