Original Article

Deregulation: Back to the future?

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ABSTRACT This paper considers the recent push for pensions deregulation in the United Kingdom and the Government's response. Ultimately, it is argued that the deregulation of pensions in the United Kingdom has, so far, been a missed opportunity for reform. The Government is quick to regulate but painfully slow at doing the opposite.

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INTRODUCTION

In May 2006, the UK Government announced a rolling deregulatory review of pensions regulation.¹ As part of this, the Government-commissioned 'Deregulatory Review of Private Pensions'² was published in July 2007 and further consultation, including the Government's response to the Deregulatory Review and the June 2008 'Risk Sharing Consultation',³ has followed.

Despite the rolling deregulatory review, this paper contends that pensions deregulation, to date, has proved to be a missed opportunity for reform. As it is, the only flexibility some employers will perceive is whether to offer pensions at all and, if they do, whether to opt for personal or occupational defined contribution provision.

BACKGROUND

The slow accretion of pensions regulation in the United Kingdom since the 1970s explains much of today's pressure on the Government to

deregulate. A once light-touch approach has been replaced by a prescriptive and, according to the Pensions Commission,⁴ 'bewilderingly complex' regime: the NAPF recently found that, since 1995, 689 sets of regulations (excluding tax) have been issued on pensions alone.⁵

Back in 1970, it was broadly possible for an employer to offer a pension of any amount, payable to the scheme member on leaving service at pension age. Early leavers might receive nothing. The amount of pension was roughly guaranteed but there were no mandatory increases imposed by Government. Pensions were viewed as a tool for employers to use in retaining staff and, as such, employers had flexibility to choose to offer what they saw as an appropriate package.

The next 30 years, however, saw the relatively free choice once afforded to employers eroded by, among other things, the following:

- Preservation requirements – employees older than 26 with at least 5 years' service (later reduced to 2 years' service) were given a right to a preserved benefit, even if they left service before retirement, by the Social Security Act 1973.

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- The introduction of contracting-out – originally a simple concept, but the need to provide protection for the part of benefits that replaced State benefits led to anti-franking legislation, ‘safeguarded rights’ for divorcees and ultimately the reference scheme test, effectively prescribing a minimum benefits level to be met for most members.
- Revaluation of accrued pensions – the Social Security Act 1985 originally provided revaluation just for subsequent service, but it was later extended retrospectively for leavers after 1 January 1991.
- Mandatory limited price indexation for all occupational pensions in payment – the Pensions Act 1995.

Of these, perhaps the one with the longest tail of consequences has been contracting-out. It gave the legislators justification to look at pensions less as part of the employers’ benefit package and more as an integrated part of the social security regime.

RECENT DEREGULATORY REVIEWS

By 2002, there was sufficient disquiet about the pensions system for the Government to commission Alan Pickering to report on ways to simplify it.⁶ Pickering noted the prescriptive, complex and detailed nature of the legislation that had come into being over the previous decades. He found that this web of rules had introduced unnecessary costs and discouraged both pension saving and provision. As a result, Pickering proposed a number of simplification measures, including allowing employers greater control over scheme design.⁶

Most of Pickering’s suggestions were, however, not taken up by the Government when it came to the Pensions Act 2004. For example, Pickering recommended a more straightforward reference scheme test to simplify contracting-out and advocated the abolition of compulsory limited price indexation for pensions in payment.⁶ Neither proposal was implemented.

Following the failure of the Pensions Act 2004 to significantly simplify pensions and to return

choices regarding pension provision to individuals and employers, pressure on the Government to deregulate continued. This culminated in the Government-commissioned Lewin and Sweeney deregulatory review of 2007² and the subsequent consultations on the Government’s response to that review.^{7,8} A number of issues arising from these reports, which highlight the Government’s cautious approach to deregulation, are discussed below.

HOW FAR DO THE GOVERNMENT’S DEREGULATORY PROPOSALS GO?

In the latest round of deregulatory proposals,⁹ the Government has indicated a number of areas where it intends to make changes, including the following:

- Provision in the Pensions Bill for the reduction of the cap on the revaluation of deferred pensions from 5 to 2.5 per cent (albeit this only applies to future service and so introduces further complexity).
- Provision in the Pensions Bill to abolish safeguarded rights currently imposed by pension sharing regulations.
- The introduction of principles-based legislation, rather than rule-driven requirements. The Department for Work and Pensions is establishing a Working Group that will aim for new legislation to be in force by April 2010.
- A statutory override to enable scheme rules to be amended to allow for future service benefit changes. This will require the agreement of both trustees and employers and will apply only to limited price indexation and revaluation caps for future service.
- The new Employer Debt Regulations.¹⁰ These regulations have already brought in periods of grace (albeit narrowly defined) in relation to statutory debt arising under section 75 of the Pensions Act 1995.

Although these are steps in the right direction, the proposals are somewhat limited at this stage:

- The work to introduce principles-based legislation will be confined initially to the

main disclosure regulations under section 113 of the Pension Schemes Act 1993 – a tiny part of the pensions legislation in existence.

- The requirement for trustee and employer consent for the statutory override will mean that, although limited price indexation was imposed entirely without employer agreement, the employer (who pays for it) cannot mitigate its obligations without trustee agreement.
- The new Employer Debt Regulations emphasise how the ability to settle statutory employer debts, which one might have expected to be a trustee decision to be taken in accordance with trust principles, has now become highly regulated. Regulations set out exactly what trustees need to be satisfied of and, largely, the terms they can agree to. This process of regulating trustee judgement is a theme to which we will return.

There have also been a number of issues raised where the Government has decided not to deregulate. These include the following:

- The decision on whether to increase pensions in payment, which will not be returned to scheme sponsors – limited price indexation will be maintained, with a cap at 2.5 per cent. The Government does not believe that ‘the removal of such an important protection for members would strike the right balance between employer concerns and member protection’.⁷
- Lewin and Sweeney’s recommendation² that a return of surplus scheme funds to the employer should be available, with the trustees’ agreement, once the scheme specific funding target is met. This recommendation will not be acted upon and the Pensions Act 1995 requirement for trustees to be satisfied that a payment of surplus to the employer must be in the scheme members’ best interests will not be removed. The Government preferred to suggest that guidance from the Pensions Regulator might be used to address concerns over ‘trapped surpluses’ instead.⁸

- Protection of subsisting rights under section 67 of the Pensions Act 1995. This is only to be kept ‘under consideration’ by the Department for Work and Pensions.⁷ The Government believes that section 67 should not prevent schemes from drafting rules that allow benefits in respect of future service to be linked to defined contingencies, albeit subject to the court’s interpretation of the Pensions Act.⁷

As a result, no substantive change is planned.

APPARENT LIMITATIONS ON THE GOVERNMENT’S APPROACH

It is difficult to reconcile the Government’s insistence on maintaining, for example, compulsory limited price indexation for pensions in payment and revaluation with the fact that occupational pensions are a voluntary part of the remuneration package employers choose to offer in order to attract and retain staff. A rather cynical conclusion is that the Government is injecting social policy into the regulation of occupational pensions. By imposing revaluation and indexation on schemes, the Government may diminish its social spending on older pensioners by protecting the real value of pensions against the effects of inflation, at the cost of the private sector. Indeed, the Government is concerned that the removal of mandatory increases to pensions in payment could ‘potentially lead to hardship’.⁷

The Government did, however, remove the requirement for limited price indexation on defined contribution pensions in 2005, which is rather inconsistent with that view. (Perhaps, though, the difference is a perception that the ‘burden’ of indexation falls on individuals in defined contribution schemes, rather than on employers.)

Limited price indexation and revaluation are, however, no protection against hardship if the underlying pension is small; indeed some employers did respond to their introduction (and other burdensome legislation) by reducing accrual rates.

It would clarify the way forward for deregulation if the Government could provide

a more cohesive rationale for the retention of limited price indexation and revaluation, as at least this would make clear the constraints within which any deregulation must work.

In refusing to reform return of surplus, the Government's actions reveal other constraints at work. The Government does not want to remove the legislative requirement that surplus return must be 'in the interests of the members'¹¹ in case this would suggest that trustees' current obligations to scheme members are being reduced.⁸ The Department for Work and Pensions has, however, stated that the relevant legislation 'reflects a trustee's general fiduciary duty to act in the interest of the scheme's members, but it does not impose a higher test than that which exists under general trust law'.⁷ If the legislation simply reflects trustees' fiduciary and trust law duties, it should be possible to remove the members' interests test from statute without diminishing trust law protections. Alternatively, if the legislation goes beyond trust law, all the more reason to remove the provision on the grounds of having been a legislative error. In any event, it should be noted that, generally, members do not have a right to surplus. The legislation is protecting mere expectations of surpluses that may not even be in existence yet. If the Government continues in this vein, deregulation is likely to be limited in scope.

There are also a number of recent examples where the Government has added to the burden of pension provision rather than simplifying or deregulating matters. Not only does the Pensions Bill merely devote two clauses to deregulation (capping revaluation for future accrual and abolishing safeguarded rights, as noted above), but it adds to the burden of providing pension schemes with the introduction of interest charges on late levy payments.¹²

Furthermore, the Pensions Regulator is to be given wider powers to appoint independent trustees and powers to intervene in the valuation process if it appears that non-prudent actuarial methods are used. This seems to restrict the scope for trustees to exercise independent judgement when managing schemes and, in practice, seems likely to create the need for trustees to act in

accordance with more regulatory requirements, which one would anticipate may be set out in guidance from the Pensions Regulator. We saw something of how this might look in the recent consultation by the Pensions Regulator on appropriate mortality assumptions.¹³

FURTHER CONSULTATION

On 5 June 2008, the Department for Work and Pensions published its 'Risk Sharing Consultation' in which it asked whether the Government should undertake a 'far-reaching deregulation of the way risks are shared in pension schemes'.¹⁴ Two main strategies that could be adopted by employers who wish to continue providing defined benefit schemes were identified: (i) managing cost (such as by reducing the accrual rate for each year of future service) and (ii) sharing risk (for example, by increasing normal pension age for future accrual in line with life expectancy). The Risk Sharing Consultation also goes on to outline alternative means to share risk, including conditional indexation and collective defined contribution approaches.

Conditional indexation would provide for revaluation of salaries and pension increases that depend on the financial health of the scheme. If the funding position of the scheme dropped below a certain level, revaluation and pension increases could be dispensed with. This again invites scrutiny of the rationale for retaining revaluation and indexation in other circumstances – if it would be acceptable to do without revaluation and indexation where a scheme is insufficiently funded, and as they are not required in defined contribution schemes, what is the rationale for not imposing them on employers with defined benefit schemes?

CONCLUSION

Many of the recent steps the Government has taken to reform the pensions regulatory environment purport to assist employers who want to be able to continue defined benefit provision for existing members. This focus on looking after existing defined benefit members,

by retaining limited price indexation, making only a limited change to revaluation and not doing more regarding surpluses, among other things, has, however, meant retaining gold-plated protection for that generation instead of taking some risks that may have ensured better provisions for all.

Decoupling pensions from the social security system altogether, recognising them as pay and largely voluntary, might have been a key to bringing about a deregulation of pensions. The introduction of Personal Accounts¹⁵ may, however, make it less likely that private pensions will be distanced from social policy, because the same justifications for interfering in scheme benefit design as arose with contracting-out will persist.

The Government, and perhaps the pensions industry as a whole, has a fascination with building on what has gone before. Although this approach prevails, it is perhaps unlikely that the outcome of any deregulatory review will bring about any meaningful simplification of our pensions system.

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- 9 See references [2,7,8].
- 10 The Occupational Pension Schemes (Employer Debt and Miscellaneous Amendments) Regulations 2008.
- 11 See Section 37 of the Pensions Act 1995.
- 12 See Parts 2 and 5 of the Pensions Bill 2007–2008.
- 13 The Pensions Regulator. (2008) *Good Practice when Choosing Assumptions for Defined Benefit Pension Schemes with a Special Focus on Mortality – Consultation Document*.
- 14 The consultation period ended on 28 August 2008. At the time of writing, the Department for Work and Pensions has not published a response to the consultation.
- 15 See Part 1 of the Pensions Bill 2007–2008.