State pension reform – the end of contracting-out

As part of its reform of the state pension system, the Government has announced that contracting-out will be abolished, probably from 2017.

Background
Contracting-out on a defined benefit (“DB”) basis was introduced in 1978 at the same time as the state earnings-related pension scheme (which was later replaced by the State Second Pension (“S2P”)). For service until 1997, schemes that contracted out on a DB basis were required to offer a guaranteed minimum pension (“GMP”), and for later service the benefits promised had to satisfy a so-called reference scheme test. Contracting-out on a money purchase basis was introduced in 1988, but has not been possible since 6 April last year.

On 14 January 2013, the Government published a White Paper setting out detailed proposals for the introduction of a single-tier (“flat rate”) state pension, most likely from 2017 but not before then, after which the state pension will no longer include separate basic and S2P elements. The White Paper also announced that, as S2P will cease, schemes will no longer be able to contract out of it on a DB basis.

Proposed reforms
The White Paper contains the following announcements directly impacting occupational pension schemes:

• DB contracting-out will be abolished when the new single-tier state pension is introduced. The Government will work with the pensions industry to set an implementation date for the abolition that allows employers to plan properly and for the abolition process to run as smoothly as possible;

• employers will be given a unilateral statutory power to change scheme rules for future service to offset the increased level of employer National Insurance Contributions (“NICs”). This statutory power will apparently allow employers to reduce future service benefits and/or increase member contributions, but only to the extent needed to offset the increase in employer NICs. This power will only be available for a limited period, and the Government will be consulting on whether there should be any further restrictions on the power;

• employers will have to consult members about any benefit or contribution changes they propose to make using the statutory power, though they will not have to consult about the fact that their schemes will no longer be contracted-out;

• the White Paper makes it clear that the new employer power will not be used in public sector schemes proper, but the Government will consult on whether it should override the Protected Persons Regulations, so that employers in privatised industries where those regulations apply (such as electricity and coal) can reduce future accrual to offset the higher employer NICs;

• there will be no further simplification of the laws on GMPs except perhaps to make it easier for schemes to convert GMPs into other benefits of equal actuarial value; and

• state pension age (“SPA”) will be increased to 67 by 2028 as previously announced, and going forward SPA will be reviewed every 5 years, the results of the first such review to be published by 7 May 2017. Should SPA be increased further following a review, all individuals affected will receive at least ten years’ notice of the increase.
Comment

Many people were concerned that the abolition of DB contracting-out and the consequential 3.4% increase in employer NICs would further increase the cost of DB provision and lead to another wave of scheme closures. The proposed employer amendment power is designed to counter these fears, but much will depend on the precise scope and wording of that power.

The Government intends to discuss the design of the power with the pensions industry, and a number of issues will need to be determined before draft legislation can be published, such as whether any areas of scheme design will be excluded from the scope of the power, how the power can be exercised in a multi-employer scheme, and how to assess whether a proposed benefit change goes beyond merely offsetting the NICs increase.

On the latter, it seems likely that some form of actuarial confirmation of equivalence will be required, which in turn raises questions such as what margin of error will be acceptable, how prescriptive any confirmation requirements should be, and whether it should be the scheme actuary or a different actuary who provides the confirmation.

The abolition of DB contracting-out raises a number of other questions which the White Paper does not answer, such as how schemes should treat post-1997 contracted-out rights after abolition: will there still be special rules about when former contracted-out rights can be transferred or how they can be amended, or will they just become ordinary scheme benefits – as protected rights did when money purchase contracting-out ended last year? No doubt there will be further consultations on these questions. Employers and trustees will need to wait for those for the answers.

If you have any questions about any of the issues raised in this update, please contact your usual Mayer Brown contact or:

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