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Money purchase deconstructed

Working with the new definition – a checklist for trustees and administrators

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The definition of money purchase benefits is changing, and with it the rules on how schemes are required to deal with any benefit which becomes classified as 'non-money purchase'. More information about these affected benefits can be found on page 3.

In broad terms, past treatment of affected benefits as money purchase will be validated. However, from the date of the definition change ('d-day' – due to be before the end of July 2014), scheme practices may need to be updated. This checklist identifies key areas which trustees and administrators should check when dealing with affected benefits from d-day onwards.

Action points

- Check whether your scheme offers any affected benefits (see page 3), which have to date been treated as money purchase benefits. Many schemes have already carried out this exercise.
- Review our checklist of key issues and decide how to deal with each of these areas to ensure compliance with the new rules. You may need to discuss the most appropriate and pragmatic approach for your scheme with us or with your actuary and administrators.
- If your scheme includes underpin or top-up benefits, there are specific additional issues to consider. These are discussed in Appendix 1.
- Remember to check any small or historic arrangements, even if they potentially affect only a handful of members.
- In some (very limited) circumstances, past employer debt calculations may need to be reviewed. See Appendix 2 and speak to your usual Allen & Overy adviser for more information.

What are 'money purchase benefits' under the new definition?

From d-day, only benefits which meet the following criteria will qualify as money purchase benefits:

– the rate or amount of a benefit other than a pension in payment must be calculated solely by reference to assets which (because of the nature of the calculation) must necessarily suffice for the purposes of providing the benefit to or in respect of the member (disregarding deductions for administrative expenses/commission); and

– for pensions in payment, the provision of the pension to or in respect of the member must be secured by an annuity contract or insurance policy made or taken out with an insurer, and the benefit must at all times before coming into payment have fallen within the description immediately above.

What are 'affected benefits'?

– A benefit with a promise attached as to the overall value of the member's pot (although not as to the amount of pension available from that overall value) – for example, an additional employer contribution at a specified age/length of service, so that the pot is increased to a multiple of salary; or a promised return on assets other than the actual return on investments (this is known as a cash balance benefit).

– A salary-related underpin for a money purchase or cash balance benefit (for example, a DC pot with a GMP underpin) (an underpin benefit).

– A promise to top up a money purchase benefit to a specified minimum value or amount, where the member only has a right to the top-up if his or her money purchase pot falls short of that defined benefit minimum (a top-up benefit).

– Any benefit within a DC arrangement which relates to salary rather than the DC pot (for example, a salary-based death benefit or ill-health early retirement pension) – but if the only non-money purchase benefits provided by a scheme are death benefits and these are secured by an insurance policy, they are not included for scheme funding purposes.

– DC pots which are converted to purchase pension income within the scheme – for example, DB schemes sometimes permit members to use their AVCs in this way) (internal annuitisation). Where trustees purchase an insurance policy as a scheme asset which provides a pension to the member, this would count as a money purchase benefit under the definition.

Important notes

Underpin benefits are only classed as non-money purchase benefits where the value of the underpin is greater than the DC pot.

If, at any date when the value of a member's DC pot and the amount of his potential **top-up benefit** is being calculated, the value of the member's DC pot is less than the defined benefit minimum promised to the member, the aggregate benefit (DC pot plus top-up value) is treated as a single non-money purchase benefit.

In the case of both underpin and top-up benefits, this may be identified at any date at which the amount of the DC pot is compared to the value of the defined benefit minimum to determine which is greater. This includes comparisons made for any purpose, but is most likely to arise on retirement/transfer or, for example, as part of a valuation process. Please see the additional notes on underpin and top-up benefits in Appendix 1.

Internally-annuitised pensions derived from money purchase benefits (for example, AVCs) are only classed as non-money purchase benefits under the regulations where the pension goes into payment after 1 April 2015.

The treatment of **cash balance benefits** depends for some purposes on whether or not the promise attached to the value of the pot is based on final pensionable earnings – this is noted where relevant in the checklist.

Treatment of affected benefits from July 2014: key issues

In broad terms, trustees of schemes which have in the past treated benefits, which are non-money purchase under the new definition, as being money purchase will not have to revisit past decisions because of the transitional protection set out in the regulations (see Appendix 2 for exceptions to this principle).

The key areas in which future practices must be brought into line with the new definition are set out below. Relatively few schemes, which have in the past been treated as wholly money purchase, are expected to be recategorised as defined benefit as a result of the definition change. However, it is not uncommon for hybrid schemes to include benefits, for example within the scheme's DC section, which may in the past have been treated as money purchase and where the treatment of those particular benefits now needs to be reviewed.

Issue	Requirement from July 2014	Comment	Notes/action required
Funding/ investment – hybrid schemes	Affected benefits must be included as non-money purchase in accounts, actuarial valuations, funding negotiations, schedules of contributions, technical provisions, recovery plans, etc for periods after d-day. For PPF purposes, the affected benefits will be taken into account for the levy year starting on 1 April 2015.	Where liabilities have been excluded from a PPF valuation because they were treated as if they related to money purchase benefits, trustees must inform the Regulator of this on or before 31 March 2015 and supply any further accounts or actuarial reports/valuations required. The PPF has power to direct an out-of-cycle valuation to assess the updated funding position of the scheme, and is currently consulting on the circumstances in which it might use that power. Consider whether your investment strategy, statement of funding principles and statement of investment principles should be reviewed/revised to take account of changes to the categorisation of any benefits. Ensure that administrators are informed and service level agreements are updated as appropriate. Review scheme information on Exchange in case updating is required (underpin benefits etc should already be recorded).	
Funding/ investment – schemes which were treated as wholly money purchase	Any scheme which becomes non-money purchase for the first time under the new definition: – must appoint an actuary on or before 6 October 2014 unless, by that date, it no longer provides any affected benefits (or is exempt under the scheme administration regulations); – will be subject to the scheme funding regime from d-day and must obtain an actuarial valuation with an effective date not more than one year from that date; and – will become eligible for PPF entry (and liable for the PPF levy) with effect from 1 April 2015.	Changes to registrable information (which includes the categories of benefits offered under the scheme) should be notified to the Regulator as soon as reasonably practicable. Ensure that administrators are informed and service level agreements are updated as appropriate.	
Revaluation	Revaluation will need to be applied to deferred non-money purchase benefits for periods of pensionable service from d-day onwards. Special rules apply if you provide cash balance benefits for early leavers, where the sum available to provide benefits is not calculated by reference to final salary (for example, a pot with a guaranteed rate of return on assets).	For periods wholly or partly **before** d-day, the money purchase method of revaluation may be used for underpin and top-up benefits and for this type of cash balance benefit, if the trustees think it appropriate. See Appendix 1 regarding underpin and top-up benefits.	

Issue	Requirement from July 2014	Comment	Notes/action required
Indexation	Statutory minimum indexation requirements will apply to pensions put into payment from the scheme on or after d-day based on cash balance, underpin or top-up benefits.	Statutory minimum indexation requirements do not apply to pensions which are already in payment from these benefits before d-day – these can continue to be paid at a flat rate (subject to more generous provision in the scheme rules).	
Disclosure	Ensure that benefits are categorised appropriately on benefit statements, statutory money purchase illustrations, etc and update basic scheme information/pre-retirement communications as appropriate. Information on the open market option must be provided in relation to cash balance benefits. Where a member has a right to cash balance benefits: – he/she will be entitled to request benefit statements on both a money purchase and a non-money purchase basis; and – basic scheme information must include a statement that the value of the pension will depend on factors including the amount of contributions paid, any guaranteed interest or bonuses applied and the cost of conversion into an annuity.	Where benefits were previously considered money purchase and change to non-money purchase from d-day, members will need a clear explanation of: – the reason for the change; – the impact for other aspects such as annual and lifetime allowance calculations; and – the effect of the change on their rights under the scheme (for example, the extent to which benefits are protected by the PPF in the event of employer insolvency – where benefits have always been treated as money purchase members may be unaware that there is any risk of benefits being affected by employer insolvency/scheme wind-up). See Appendix 1 regarding underpin and top-up benefits.	
Transfer values/cash transfer sums	Transfer values/cash transfer sums in relation to cash balance benefits where the available sum is not calculated by reference to final pensionable earnings can be calculated at the current value of the fund where pensionable service terminates after d-day.	This includes any notional interest, guarantees, bonuses or discretionary payments. The value would be subject to an adjustment if the scheme is underfunded. For cash balance benefits where the available sum **is** calculated by reference to final salary, the rules for salary-related benefits will apply.	
Pension sharing	Valuations on or after d-day must be made on the appropriate basis under the new definition. Where a valuation of pension rights or the implementation of a pension sharing order has been provided before, or is in process as at, d-day, calculations will not have to be revisited.	This applies to cash balance, underpin and top-up benefits and pensions derived from them, and to internally-annuitised money purchase benefits.	
Employer debt	Affected benefits must be taken into account on future section 75 calculations, apportionment arrangements, bulk transfers and winding-up.	Extensive transitional protection is provided in relation to periods before d-day, but see Appendix 2 for exceptions.	

Comment

The extensive transitional protection offered by the new regulations is good news for trustees and administrators, but as demonstrated in this briefing, there are still many areas of potential complexity to navigate. Pragmatic solutions may be required to achieve the best outcome for your scheme and members: please contact your usual Allen & Overy adviser or get in touch with any of the partners in our Pensions team to discuss matters further.

Contact details can be found on page 2.

Appendix 1

Underpin and top-up benefits

For most affected benefits, categorisation of a benefit as money purchase or non-money purchase will be determined at d-day. However, the classification of underpin and top-up benefits could potentially change from one period to another, for example if a valuation reveals that a defined benefit minimum is greater than the money purchase pot as at the date of that valuation. A change in the markets/assets held between that valuation and the next could lead to a different result.

This gives rise to some complex issues. From a member perspective, minimum compliance with the basic disclosure requirements could cause confusion and uncertainty (for example, to a member who receives a statutory money purchase illustration in one year, and in another year, scheme information on defined benefit rights). A pragmatic way forward may be to issue hybrid statements explaining both benefits and the circumstances in which they apply. This achieves consistency for members, but at the expense of 'over-compliance' by the scheme.

Annual and lifetime allowance calculations

The categorisation of benefits as money purchase or non-money purchase will determine the calculation method for annual and lifetime allowance purposes. In practice, many administrators carry out annual allowance calculations for anyone who might potentially trigger a charge (and for other members who request it), in order to issue a pension savings statement.

The parameters governing which benefits need to be checked should be reviewed and revised. Members must be able to access correct information about their pension input amount in any particular pension input period – for example, they may want to assess the amount of annual allowance available to roll over to a future year. You may need to review whether your current systems are designed to deal with calculations on a dual basis. In addition, members are likely to need additional information to explain why pension input amounts following d-day look quite different to what they had expected, or why they may differ from one year to the next.

On what basis, and how often, should you value underpin and top-up benefits?

At any given testing point, such as on a transfer or retirement, the value of the defined benefit minimum will be calculated (including revaluation) and compared to the money purchase pot at that date. Different valuation bases apply for different purposes and, as with any actuarial calculation, the outcome will vary depending on the assumptions used. As a result, the answer to whether an individual's benefits are money purchase or non-money purchase may depend, for example, on whether they are being valued for PPF levy purposes, or as part of a scheme valuation, or to provide a cash equivalent transfer value.

The likelihood of benefits switching from money purchase to non-money purchase or vice versa will also depend on the scheme structure (for example, how generous the contribution rate is) and may vary between members in different age brackets. You will need to discuss options with your usual Allen & Overy adviser and your scheme actuary to determine the appropriate strategy for your scheme.

The importance of being 55

One particular point at which it is likely to be relevant in future to know whether benefits are money purchase or not is when members are approaching age 55, so that they know whether the proposed new flexibility around accessing DC savings is available to them. This will be particularly significant if there is any form of restriction on DB to DC transfers, which will not be known until the Government responds to its consultation on the issue (which we expect before the end of July 2014). However, the approach of a member's 55th birthday is in any event likely to become a trigger to request information about their benefits, and scheme administrators should take steps to prepare for this.

Appendix 2

Reviewing past actions: employer debt calculations

The regulations make it largely unnecessary to re-examine past actions, except in two situations relating to employer debt calculations. If your scheme falls within either of the following categories, action may be required:

	Scheme previously treated as wholly money purchase	Hybrid scheme
Type of benefits offered by scheme	Any form of non-money purchase benefits other than: – death benefits; – cash balance benefits; or – pensions derived from money purchase or cash balance benefits.	Any form of non-money purchase benefits apart from: – death benefits; – cash balance benefits; – top-up benefits and the defined benefit minimum of underpin benefits; and – pensions derived from these or from money purchase benefits.
Previous treatment for employer debt purposes	Existence of non-money purchase benefits outside these categories (for example, top-up benefits or the defined benefit minimum of underpin benefits) was ignored. Employer debt regime treated as not applicable to scheme.	Non-money purchase benefits outside the above categories were excluded from a previous calculation of scheme assets and liabilities for section 75 purposes, on the basis that they were money purchase.

Even if your scheme fall within either of these categories, a new section 75 debt is not inevitable. If an ongoing scheme's statutory funding objective is met or a recovery plan is agreed (on the basis of a valuation with an effective date within the three years before or 12 months after d-day) then no further action need be taken. If a scheme is winding up underfunded, or a recovery plan cannot be agreed for an ongoing scheme in relation to any deficit revealed by the valuation referred to above, and in either case there is at least one solvent employer participating in the scheme, a debt may need to be imposed.

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