Work and Pensions Committee: Defined Benefit Pension Schemes

Submission by Prospect

April 2023

www.prospect.org.uk

Introduction

1. Prospect is a trade union representing over 155,000 employees and freelancers across the public and private sectors.

2. Our evidence to the Committee's current inquiry into defined benefit pension schemes is focussed on the questions in the call for evidence about the funding of the Pension Protection Fund (PPF) and compensation payable to PPF members.

3. These issues are particularly important to Prospect because many of our members are currently receiving compensation from the PPF or will do so in the future.

4. While we welcome the introduction of the PPF and acknowledge that it generally leads to better outcomes for scheme members in the event of the insolvency of sponsoring employers, we believe it is time to review the compensation it provides.

Summary

5. The funding position of the PPF is very strong, thanks to excellent investment performance and reduced risk of claims. As a result, the PPF levy has been reduced and there are plans to reduce it further. PPF members have not shared the benefits of the improved funding position. This should be rectified as soon as possible. This will require legislation because the Board of the PPF has limited ability to pay compensation in excess of the levels set in the Pensions Act 2004.

6. Parliament must consider what legislation may be needed to address any future "surplus" in the PPF and to ensure that the interests of members and their dependents are properly represented in any deliberations.

7. The lack of increases for compensation in respect of "pre-1997" service is devastating for members, particularly during the current cost of living crisis, and discriminates against women and older members. The Committee should recommend that government legislates to get rid of the arbitrary difference in treatment for compensation in respect of "pre-1997" and "post-1997" service.

8. The Committee should ask representatives of the Board of the PPF about its policies in respect of the discretion it has under the Pensions Act 2004 to increase compensation by more than the cap of 2.5%.

9. The Committee should recommend that government retain the minimum levels of protection of benefits payable by the PPF under the Hampshire and Bauer judgments from the CJEU.

Background

10. The PPF was established by the Pensions Act 2004 to act as a lifeboat for members of defined benefit pension schemes that were sponsored by employers who became insolvent and where there were insufficient assets in the pension fund to cover a protected level of benefits.

11. It is funded from several sources. Pension schemes eligible for PPF protection pay pension protection levies.

12. The PPF also takes on the assets of any pension scheme that is transferred into it and can seek to recover money or other assets from any insolvent employer that sponsored a scheme that has been transferred into it.

13. Investment income is another significant source of income for the PPF.

14. The PPF does not cover the value of all the benefits built up in the defined benefit scheme. The value of benefits covered has changed over time.

15. Scheme members over Normal Pension Age, or who are already in receipt of a survivor or ill-health pension, generally receive 100% of the benefit under the scheme's admissible rules.

16. Members under Normal Pension Age, including those already receiving pension, are generally entitled to 90% of the level of accrued benefit under the admissible rules.

17. Initially members who were subject to the 90% restriction also had an overall compensation cap applied. From 6 April 2017, the compensation cap was increased by 3% for every year of service in the scheme in excess of 20 years up to a maximum of twice the standard cap. In July 2021, the Court of Appeal ruled that the compensation cap was unlawful on the grounds of age discrimination (in 'Hampshire V the Board of the PPF'[1]) and it was subsequently disapplied.

18. Compensation in relation to pensionable service from 6 April 1997 is increased in line with inflation (as measured by the Consumer Prices Index) subject to a maximum of 2.5%. Compensation in relation to pensionable service before 6 April 1997 does not attract any increase. Increases are applied on 1 January each year (based on the increase in the CPI in the 12 months to the previous May).

19. In its ruling in 'Hampshire V the Board of the PPF'[2], the CJEU clarified that the requirement in EU law had to be interpreted to mean that every individual employee must receive old-age benefits corresponding to at least 50% of the value of their accrued entitlement under a supplementary occupational pension scheme in the event of their employer's insolvency.

20. In the Bauer case[3] the CJEU went further, ruling that that even where members are receiving 50% of their accrued rights, a reduction to those rights is 'manifestly unjust' where it would cause the member to live below the at-risk-of-poverty threshold (as determined by the EU statistical office, Eurostat).

21. The CJEU rulings in Hampshire and Bauer are retained EU law. Under the Retained EU Law (Revocation and Reform) Bill the effect of these judgment is expected to be revoked because they conflict with government policy.

[1] Hampshire v The Board of the Pension Protection Fund - Find case law (nationalarchives.gov.uk)
[2] EUR-Lex - 62017CJ0017 - EN - EUR-Lex (europa.eu)
[3] EUR-Lex - 62018CJ0168 - EN - EUR-Lex (europa.eu)

Implications of improved funding levels for the PPF

22. According to the PPF's latest annual report and accounts[4], the scheme held £39 billion in invested assets as at 31 March 2022. At that point, the PPF estimated it held £11.7 billion above what it needed to pay every current member and their dependants their compensation for life. This represented a funding ratio of 137.9%.

23. Figures as at 31 March 2023 are not available yet, but these are likely to show an even better funding position as the discount rate applied to future payments and expenses is likely to be much higher due to movements in gilt yields over the last year.

24. The funding position of the schemes covered by the PPF is also very healthy. The latest annual report and accounts (as at 31 March 2022) reported the total deficit of schemes eligible for the PPF that were reported to be in deficit (measured on a Section 179 basis) had fallen from £128.5 billion to £62.9 billion.

25. This trend continued through 2022-23 for the same reason that the funding position of the PPF itself is anticipated to have improved over the year (higher discount rate due to changes in gilt yields). The March 2023 PPF 7800 Index[5] reported that, at the end of February, only 672 schemes were in deficit and that their cumulative deficit was just £4.2 billion.

26. The improved funding position clearly has a number of implications. In the first instance, it has enabled the PPF to significantly reduce the levy payable by eligible schemes. The table below shows the PPF levy (actuals from accounts and estimates for latest years).

Year	2005/06	2006/07	2007/08	2008/09	2009/10
Levy	£138m	£270m	£577m	£646m	£589m
Year	2010/11	2011/12	2012/13	2013/14	2014/15
Levy	£691m	£605m	£648m	£577m	£574m
Year	2015/16	2016/17	2017/18	2018/19	2019/20
Levy	£558m	£585m	£537m	£561m	£567m
Year	2020/21	2021/22	2022/23	2023/24	
Levy	£630m	£475m	£390m	£200m	

27. In addition to the reductions in the levy that have already been implemented, the PPF's latest funding strategy[6] refers to working with DWP to enable legislative change "to support further reductions in levy in future years". This gives a clear

[4] Annual Report 2021/22 | Pension Protection Fund (ppf.co.uk)
[5] PPF7800 Index
[6] Long-Term Funding Strategy Review 2022 Review 2022 (ppf.co.uk)

steer that the PPF anticipates “charging a much lower levy in the future” as it journeys through its maturing phase.

28. Unlike levy-payers, PPF members have not benefited from the improvement in funding levels. There is a strong case for immediate improvements in compensation to reflect the improved funding position. The Board of the PPF currently has limited discretion in relation to improving compensation levels, so legislation will be necessary in this area. This is considered in more detail in the next section.

29. There is also a wider question about what should happen to any “surplus” in the PPF. The PPF’s policy statement on levy rules for 2023/24[7] pointed out that the Pensions Act 2004 is silent on what would happen to any PPF excess reserves. On this point, the departmental review of the PPF[8] recommended:

    “That the DWP and the PPF work together to understand the implications of the PPF’s funding position in light of expected future developments in the population of Defined Benefit (DB) pension schemes and plan well ahead for any legislative changes that might be needed; for example, to address what happens to any funding which is surplus to requirements.”

30. Clearly there are longer-term questions about the distribution of potential “surplus” in the PPF. It is vital that PPF members’ interests are represented in these conversations and that any legislation allocates an appropriate share of any “surplus” to PPF members and their dependents.

Should changes be made to the PPF to improve outcomes for members?

31. There is a strong case for sharing the benefits of the PPF’s improved funding position with members. Prospect’s preferences for compensation improvements are set out in detail below. The Board of the PPF currently has limited flexibility in paying more compensation than provided for under the Pensions Act 2004, so legislation will be necessary to enable compensation improvements.

    - **Indexation of compensation in relation to pensionable service before 6 April 1997**

32. The Pensions Act 2004 only provides for increases to compensation that is attributable to “post-1997” service. Compensation in relation to pensionable service before 6 April 1997 attracts no increase.

33. The choice of the level of indexation (for both “pre-1997” and “post-1997” service) was the subject of debate during the passage of the Pensions Act 2004 through Parliament.

34. In the debate of the grand committee on the pensions bill in the House of Lords on 9 September 2004[9], the minister stated that the decision not to provide for any increase in compensation in relation to pensionable service before 6 April 1997 was the result of “hard choices”.

[7] Policy statement - Dec 2022 (ppf.co.uk)
[8] Departmental Review of the Pension Protection Fund (PPF) - GOV.UK (www.gov.uk)
[9] Official Report Of The Grand Committee On The Pensions - Hansard - UK Parliament

35. The minister stated that the alternatives to better compensation increases were: a much higher levy, taxpayer subsidies (funded, in part, by people with no occupational pension at all) or a cut to compensation levels (of about 15%).

36. It is important to understand how this rule impacts PPF members. The table below shows the theoretical value of £100 per year of PPF compensation put into payment on 1 January 2005 would be if it was increased in line with uncapped inflation (as measured by CPI) every year since then. If the compensation entirely related to service before 6 April 1997, then it would still only be worth £100 per year now. This represents a fall in purchasing power of well over 50%.

Year	CPI (to previous May)	Compensation
2006	1.9%	101.9
2007	2.2%	104.1
2008	2.5%	106.7
2009	3.3%	110.3
2010	2.2%	112.7
2011	3.4%	116.5
2012	4.5%	121.8
2013	2.8%	125.2
2014	2.7%	128.6
2015	1.5%	130.5
2016	0.1%	130.6
2017	0.3%	131.0
2018	2.9%	134.8
2019	2.4%	138.0
2020	2.0%	140.8
2021	0.5%	141.5
2022	2.1%	144.5
2023	9.1%	157.6

37. As well as the size of the impact, it is also important to appreciate the disproportionate effect on members with certain protected characteristics.

38. In May 2023, Prospect submitted a Freedom of Information request asking for the proportion of PPF members who were entitled to (1) no inflation protection and (2) some inflation protection by age and gender. The response[10] showed that women

[10] https://library.prospect.org.uk/download/2023/00469

and older members were more likely to receive compensation that did not attract any inflation increases. The data by sex and age is set out in the following tables.

	No increase	Some increase
Men	24.6%	75.4%
Women	34.7%	65.3%

	No increase	Some increase
Under 65	18.0%	82.0%
65 to 75	26.1%	73.9%
75 to 85	38.0%	62.0%
Over 85	83.3%	16.7%

39. This shows that the devastating impact of the lack of inflation protection for compensation for “pre-1997” service disproportionately impacts women and older members. There is no justification for this differential treatment. It should be rectified by eliminating the artificial distinction between pension built up “pre-1997” and “post-1997”.

40. Prospect wrote to the Pensions Minister in May 2022[11] to raise the issue of whether compensation levels were adequate in the context of the inflationary environment at the time and whether he was confident that the Board of the PPF’s approach to the Hampshire judgment properly took the then level of inflation into account. In response[12] the minister indicated that he believed the approach to both issues was appropriate.

41. During the passage of the Pensions Act 2004 through Parliament, ministers justified the lack of inflation protection for compensation in relation to “pre-1997” service because there was no statutory requirement for eligible schemes themselves to increase the underlying pension. Data on the pension increases actually paid by private sector schemes in relation to “pre-1997” service showed the vast majority received some increase (the minister herself conceded in the debate that 90% of schemes paid some increase, the proportion of scheme members entitled to an increase will have been much higher). This is not a rational justification for this discriminatory treatment.

- **Indexation of compensation in relation to pensionable service after 6 April 1997**

42. As noted above, compensation in relation to pensionable service from 6 April 1997 is increased in line with inflation (as measured by the CPI since 2012) subject to a maximum of 2.5%.

[11] https://library.prospect.org.uk/download/2022/00896
[12] https://library.prospect.org.uk/download/2022/00897

43. The justification for this approach was that the Pensions Act 1995 first introduced the requirement to increase occupational pensions in line with inflation (as measured by the Retail Prices Index), though this was capped at 5%. The Pensions Act 2004 subsequently reduced the cap to 2.5% and the Pensions Act 2011 essentially changed the index from RPI to CPI.

44. While this is more generous treatment than for compensation in relation to pensionable service before 6 April 2007, it can still result in a significant reduction in the purchasing power of compensation over time. The following table shows what the theoretical value of £100 per year of PPF compensation put into payment on 1 January 2005 would be if it was increased in line with uncapped inflation (RPI to 2011 and CPI afterwards), compared to the actual capped increases that apply to "post-1997" service.

Year	Index	PPF Increase	Uncapped	Capped
2006	2.9%	2.5%	102.9	102.5
2007	3.0%	2.5%	106.0	105.1
2008	4.3%	2.5%	110.5	107.7
2009	4.3%	2.5%	115.3	110.4
2010	0.0%	0.0%	115.3	110.4
2011	5.1%	2.5%	121.2	113.1
2012	4.5%	2.5%	126.6	116.0
2013	2.8%	2.5%	130.2	118.9
2014	2.7%	2.5%	133.7	121.8
2015	1.5%	1.5%	135.7	123.7
2016	0.1%	0.1%	135.8	123.8
2017	0.3%	0.3%	136.2	124.2
2018	2.9%	2.5%	140.2	127.3
2019	2.4%	2.4%	143.6	130.3
2020	2.0%	2.0%	146.4	132.9
2021	0.5%	0.5%	147.2	133.6
2022	2.1%	2.1%	150.2	136.4
2023	9.1%	2.5%	163.9	139.8

45. The data above shows that capping compensation for "post-1997" service in this example would have reduced its purchasing power by over 17% by now.

46. It is possible that ministers underestimated the impact of the cap on compensation increases when it was first proposed. In the white paper following its consultation on the level of inflation protection to require in occupational pension schemes, the government stated[13]: “In 1995, when the legislation introducing LPI was passed, long-term expectations of inflation were significantly higher: the 5 per cent cap was only intended to provide for partial cover against inflation. But the Government’s success in reducing inflation means that mandatory indexation has effectively become full inflation cover, something which is proving disproportionately expensive for some schemes to provide.”

47. Another difference in the treatment of increases for compensation in respect of “pre-1997” and “post-1997” service, is that the Pensions Act 2004 gives the Board of the PPF discretion to apply a different increase to compensation in respect of “post-1997” service than stated above (Paragraph 29(2) of Schedule 7: “The Board may also determine the percentage that is to be the appropriate percentage for the purposes of paragraph 28 (and where it does so the definition of “appropriate percentage” in paragraph 28(3) does not apply).”).

48. This means that the Board already has discretion to increase compensation in respect of “post-1997” service by more than 2.5%. The Committee should question representatives of the Board of the PPF about its policy for applying this discretion and the assessment it made about applying it to increases from 1 January 2023.

- **Minimum required level of compensation**

49. The CJEU established the minimum levels of compensation payable in the Hampshire and Bauer cases (50% of accrued benefits subject to any reduction not taking benefits to a level where it would cause the member to live below the at-risk-of-poverty threshold).

50. At the fourth sitting of the House of Commons bill committee for the Retained EU Law (Revocation and Reform) Bill[14] amendments were proposed to retain these minimum levels of compensation.

51. The government rejected these amendments because the judgments are “a clear example of where an EU judgment conflicts with the UK government’s policies”.

52. This is a desperately disappointing position. At no point did Brexit campaigners cite lower pension protections as a benefit of leaving the EU. These changes are unnecessary given the funding position of the PPF. The Committee should recommend that government retain the current minimum level of protection.

[13] Occupational pension increases - House of Commons Library (parliament.uk)
[14] Retained EU Law (Revocation and Reform) Bill (Fourth s - Hansard - UK Parliament