Church of England Pensions Board

Church Workers Pension Fund

Section 75 of the Pensions Act 1995

Introduction

1. This technical note describes the provisions of Section 75 of the Pensions Act 1995, how they apply to the Church Workers Pension Fund (CWPF), and the Board's proposals for handling such debts. The note is divided into the following sections:

   Section A – a description of the Church Workers Pension Fund

   Section B – an outline of the provisions of Section 75

   Section C – what has changed since 2009

   Section D – revised proposals for handling Section 75 issues

SECTION A – THE CHURCH WORKERS PENSION FUND

Structure of the CWPF

2. The CWPF contains two distinct sections – the Church of England Pension Builder Scheme (PBS) and the Church of England Defined Benefits Scheme (DBS). The PBS then has two further sections, Pension Builder Classic (PBC) and Pensions Builder 2014 (PB 2014). The scheme, however, is a single trust and there is no legal separation of the assets between the two sections. For the purposes of scheme management, the two sections are separated on a notional basis: each section is monitored separately and has its own investment strategy etc. The split between the two sections is shown in the scheme accounts.

The Church of England Pension Builder Scheme

3. The PBS (formerly known as the Defined Contribution Scheme or DCS) is a defined contribution arrangement in that the employer undertakes to pay a set percentage of a member's salary by way of contributions. However, there are features of PBC and PB 2014 which give the PBS some characteristics of a defined benefit arrangement, and it may therefore be regarded as a "hybrid" scheme.

4. In a conventional defined contributions scheme, contributions are invested and accumulate with investment returns, often linked directly to movements in the stock market. At retirement, the accumulated fund is used to buy an annuity from an insurance company or taken in the form of a lump sum (which is tax-free within certain

limits). Members are therefore exposed to investment risks while the fund is building up and to annuity risk at the point of retirement. Annuity rates fluctuate and it cannot be known in advance what rates might be available when the annuity comes to be purchased.

5. In PBC, contributions are converted on receipt into an amount of pension payable from the scheme's normal pension age - this is sometimes referred to as a "deferred annuity" approach. In PB 2014, contributions are allocated to a notional account for each member and this notional account is used to determine benefits at normal pension age. Investment returns in excess of the amounts needed to provide these benefits are shared amongst members by the declaration of discretionary "bonuses".

6. Because this type of arrangement contains an element of guarantee, the fund is subject to triennial valuations. PBC is valued on the assumption that bonuses will be granted in line with the Retail Prices Index. PB 2014 is valued on the assumption that bonuses will be granted in line with investment returns, net of expenses. These levels of bonus are not, however, guaranteed. The guaranteed benefit is the amount accumulated in PBC or PB 2014 without any allowance for future bonuses. The guaranteed benefit is payable from a designated Normal Retirement Date. For retirements before this date, a reduction will be applied to the PBC pension (to reflect the longer period of payment) and a reduction is likely to be applied to the PB 2014 benefit, depending on investment conditions at that time. Where a valuation reveals that there is a deficiency on the ongoing funding basis, then the principal mechanism for restoring the scheme to balance is to reduce or suspend bonuses for a period.

Church of England Defined Benefits Scheme

7. Employers may choose from a wide range of possible benefit structures in DBS. Employers fund for their own members on the basis of their chosen benefit structure and membership profile, and contribution rates are set separately for each employer. A notional "pool" of the overall fund is set aside for each employer into which contributions are paid and from which benefits are paid. The DBS may therefore be thought of in practice as a collection of individual schemes, operating under a single umbrella, although the schemes are not legally or financially separate.

8. Most employers participating in the DBS are too small individually to take on mortality risks. There are two main risks involved:
    - the risk of a member dying in service, triggering payment of a substantial lump sum death benefit; and,
    - longevity risk, i.e. it is not known at the point of retirement for how long a pension will be paid.

9. Small schemes would traditionally insure death in service benefits, and purchase annuities at retirement, thereby removing the risks by moving them to an insurance company. Although individual employers are too small to carry these risks, the scheme as a whole is large enough and a further notional section, known as the "Life Risk Section" (LRS), sits alongside the individual employers' pools acting in many ways like an

in-house insurance company. The LRS provides the death in service benefits and pensions in retirement;

- where an employer has active members, a "premium" is calculated each year and transferred from the employer's pool to the LRS to "insure" the death in service benefits, and,
- when a member retires, the actuarial value of the pension to be provided is transferred from the employers notional pool to the LRS, which then takes on the responsibility for paying pensions.

10. The LRS thus allows even small employers to be able to operate a defined benefit scheme. It should also achieve some cost savings in that no insurance company profit is involved and the LRS is able to retain a limited equity exposure rather than being invested entirely in gilts (which would be the investment underlying a purchased annuity).

11. LRS also holds responsibility for "orphans", i.e. deferred members and pensioners of those employers that no longer participate in the scheme, where those employers have no further responsibility to fund benefits. Orphan liabilities usually derive from employers who ceased to have active members in DBS before the current Section 75 regulations came into force.

12. The funding position of the LRS is assessed as part of the valuation process. At any time it is likely to have a surplus or deficiency against the actuarially assessed value of its liabilities. If the surplus or deficiency is relatively small then it is likely that the Pensions Board would decide to roll it over to the next valuation. Where the difference is more significant, however, some action may need to be taken.

13. Where there is a surplus the Board may (but need not) decide to distribute a proportion amongst the participating employers' pools, improving their funding. Where there is a deficiency then the Board may decide to make a levy on participating employers' pools to make good some or all of the deficiency. Over the years both situations have occurred. However, at the last valuation at the end of 2010, there was a deficiency in the LRS and a levy was made on employers' pools in proportion to the amounts each pool had transferred to the LRS to provide pensions in payment.

14. As described above, there is a sharing of risk between employers in relation to mortality risks and in relation to the orphan liabilities in the LRS. Other than that, however, so far as is consistent with applicable law, each employer is responsible for funding benefits for its own members.

SECTION B – SECTION 75 OF THE PENSIONS ACT 1995

Debts under Section 75

15. The Pensions Act 1995 introduced the concept of a "debt" arising when an employer in a multiple-employer scheme ceased to have any active members. This test was related to the Minimum Funding Requirement (MFR) then in force. MFR funding levels were typically lower than ongoing funding levels. No debt arose when a scheme was funded to the level of the MFR. As the CWPF had always been funded above the MFR level, this legislation therefore had no impact on the scheme.

16. The Pensions Act 2004 abolished the MFR and changed the calculation of the debt, making it much more stringent. The test is now related to the cost of buying out benefits with an insurance company. The funding level required for that is generally very much higher than for ongoing funding and it is very common for schemes that are fully funded (or even in surplus) under the ongoing funding measure to have a deficiency on the buyout measure.

17. The Regulations made under Section 75 are extremely complex. The government has also had great difficulty in making them workable. The original regulations which were laid in 2005 were amended in 2007 and again in 2012. The government is still being pressed by the pensions industry to make further changes to simplify the operation of Section 75.

Calculation of the debt

18. As the CWPF is legally a single scheme, and because of the guarantees underlying the benefits in the PBS, the Section 75 debt is calculated over the scheme as a whole. This meant that under the regulations as they stood after 2005, employers in both the PBS and DBS shared in the experience of the scheme as a whole – there was no segregation between the two sections and no ability to limit exposure to an employer's pool.

19. The way the regulations are framed, and unless an alternative arrangement is put in place, the departing employer's debt is calculated as follows:

$$(\text{Total scheme liabilities} - \text{total scheme assets}) \times \frac{\text{Liabilities of departing employer}}{\text{Total scheme liabilities}}$$

20. It will be noted that there is no reference in the formula to the assets in the departing employer's pool.

Problems with the legislation

21. The legislation creates two major problems for the CWPF:

    - Employers within the PBS were exposed to deficiencies within the DBS section (and vice versa); and

    - Employers within the DBS who had funded their pools to a higher level than other employers received no benefit for doing so in terms of Section 75 liabilities.

22. In general, employers participate in PBS rather than DBS because they want to limit their exposure to funding risk. The major commitment is to pay a contribution at a predetermined level although there is a residual risk because of the nature of the underlying guarantees given on the benefits. In the opinion of the Board as trustee, it is unreasonable that PBS employers should be exposed to financial risks resulting from decisions of employers participating in the DBS.

23. The key principle behind the funding of the DBS is that each employer is, as far as possible, responsible for funding the benefits of its own employees and former employees. The exception is where there is explicit risk-sharing, principally in the operation of the Life Risk Section, which is to the advantage of all employers. As can be seen from the formula above, the Section 75 debt calculation takes no account of the actual level of funding of that employer's pool. So, for example, the Section 75 debt would be identical for an employer which had liabilities in its own section of £1 million with assets of £0.5 million as it would be if the assets were £1 million. The Board as trustee believe this untenable as it would expose employers to risks associated with decisions made by other, unconnected, employers.

24. There is also a problem in relation to the mechanics of valuing a departing employer's Section 75 debt. The regulations require a full actuarial valuation of CWPF at the date an employer withdrew from the scheme and stipulated that the cost (which would be considerable) would be met by the departing employer. However, most departing employers are small, participate in PBS, and would be without the resources to pay those costs. In those circumstances the cost would fall back on the employers in DBS schemes and members in PBS. (Members in PBS would receive a lower pension than might otherwise be expected because of the additional financial strain on PBS caused by the costs of administering Section 75 in this way.)

Arrangements to address the problems identified

25. Since 2009 all participating employers have agreed with the Board to take advantage of a clause in the legislation which said that schemes could make alternative arrangements by apportioning a Section 75 debt differently from the default position in legislation. The most recent mechanism adopted is a "flexible apportionment arrangement" (FAA).

    The arrangements has the effect – so far as permitted by legislation - of:

- treating the DBS and PBS separately for the purposes of Section 75, so that there is no cross-subsidy between them. Thus PBS employers became responsible for any shortfall in that section only, and DBS employers for any shortfall in that section;

- in the DBS, altering the calculation so that the level of assets in an individual employer's pool was taken into account, in effect treating each employer's section as a stand-alone scheme. This removed a perverse incentive for employers that expect a cessation event (e.g. having no remaining active members) deliberately to underfund their own pool;

- easing the requirement for a full actuarial valuation and enabling a much simplified (and thus lower cost) but equitable method of carrying out the required calculations.

26. Under those arrangements the Section 75 debt is calculated as:

Liabilities attributable to the departing employer	***less***	Assets attributable to departing employer (plus an appropriate share of "orphan" liabilities)

27. The arrangements put in place also allow the Board to adopt a different approach if the circumstances warranted it. For example, where two participating employers merge and trigger a cessation event, the Board might agree to apportion the debt in full to the new organisation rather than insisting on it being paid immediately. A withdrawing employer remains liable for its own costs (unless the contrary is specifically agreed) but we generally expect those to be less than under the default procedure.

28. These arrangements effectively restored the position to what it was prior to the 2004 legislation and reduced the risk to employers of decisions made by other organisations.

29. Please note that legislation requires the Trustee to be satisfied on a number of matters when an employer ceases to have active members (or becomes insolvent, or on winding up of the Fund). If the Trustee is not satisfied, it may not be possible to use an arrangement such as a FAA and the default position will have to be applied. While we do not anticipate this type of difficulty, it cannot be guaranteed.

Other points

It must be remembered that, in the context of an employer continuing to participate in a scheme, a Section 75 debt is a largely theoretical one. It only arises on a "cessation event", i.e. where an employer ceases to have any active members or in certain other situations such as the scheme winding up. While an employer continues to have active members within the scheme no debt will arise. This includes the situation where an employer ceases to have active members in the DBS but continues to have active members in the PBS.

SECTION C – REVISED PROPOSALS FOR HANDLING SECTION 75 DEBTS

30. The Board has recently had cause to review the above process specifically in relation to the PBS. Having reviewed the arrangements currently in place with its lawyers and actuarial advisers the Board has concluded that a further adjustment is needed to fully reflect the introduction of the recent introduction of PB 2014.

31. The Board is now seeking the agreement of all employers participating in the PBS to these adjustments. Further agreement from employers participating in the DBS is not required as their position is unchanged. However, the Board will be writing to all employers, including the DBS employers, in due course to confirm the amended arrangements.

32. Although PBC and PB 2014 operate in a similar way, the benefit structure of PB 2014, if considered separately from all other aspects of the CWPF, was designed to provide a low risk option for employers in the sense that the scheme design is unlikely to lead to a deficit arising. Therefore, the Board has decided that it is appropriate for a further apportionment of liabilities to be introduced into the PBS so that there is no cross-subsidy between employers in PBC and PB 2014. The effect is that PBC employers and PB 2014 employers will become responsible for any shortfall in their own respective sections of PBC.

33. Because of flexibility introduced in the Rules of the CWPF a little while ago, the above can be implemented without further amendments to the Rules but does require the agreement of all employers currently participating in the PBS. In addition, all employers seeking to join the CWPF in the future will be required to agree to the amended arrangements.

34. Please return the enclosed form as evidence of your agreement.

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The Church of England Pensions Board
29 Great Smith Street
London
SW1P 3PS