



Independent Trustees



Briefing note – July 2015

Contracting-out changes: challenges for employers and trustees

The ability for defined benefit (DB) pension schemes to contract out of the additional State Pension (S2P) will come to an end on 5 April 2016, when S2P is replaced by the new single tier State Pension. This change brings challenges for both pension trustees and scheme sponsors of open DB schemes, and it is important you **know what actions you need to take**.

What are the issues?

Employers

The key issue with the end of contracting out is the **increase in payroll costs**. From April 2016, employers will need to pay National Insurance at the standard rate rather than the contracted-out rate - an **increase of 3.4% of all earnings above the secondary threshold** in respect of DB scheme members.

Employees who are members of the scheme will also be affected. Their National Insurance contributions will rise by 1.4%, meaning their **take home pay will reduce**.

You also need to consider how the ending of contracting-out affects the scheme itself, for example whether **alterations to scheme design** are needed. If changes are proposed, a consultation process with employees will be required. We look at this in more detail later.

Trustees

Reconciling contracting-out data with HMRC is the big issue for pension trustees. We looked at this in more detail in our May 2015 briefing *'GMPs: to reconcile or not to reconcile? That is the question.'*

Any changes to the scheme will need implementing and clearly communicated to members.

1	Assess impact on payroll costs	
2	Consider effect on workforce - e.g. take-home pay	
3	Look at possible design changes or consider closing scheme for future accrual	
4	Consider ways to achieve your desired outcome - e.g. altering the accrual rate or changing contribution levels?	
5	Can changes be made using the scheme's amendment power?	
6	Will you use the statutory override?	
7	Plan any consultation and communications	
8	If the scheme is used for auto-enrolment, will the certification basis need to be considered?	

Initial preparations for the ending of contracting-out fall, in the main part, to the employer. Consideration needs to be given to a number of factors and decisions need to be made about the future design and operation of the scheme - the **actions checklist** on the next page provides more details.

Employer actions checklist

1	Assess impact on payroll costs	
2	Consider effect on workforce - e.g. take-home pay	
3	Look at possible design changes or consider closing scheme for future accrual	
4	Consider ways to achieve your desired outcome - e.g. altering the accrual rate or changing contribution levels?	
5	Can changes be made using the scheme's amendment power?	
6	Will you use the statutory override?	
7	Plan any consultation and communications	
8	If the scheme is used for auto-enrolment, will the certification basis need to be considered?	

What is the statutory override?**Employers**

The Pensions Act 2014 gave employers running contracted-out DB pension schemes the **power to make certain unilateral changes** to help offset the increase in National Insurance contributions. This 'statutory override' can be used for:

- **reducing future benefit accrual;**
- **increasing member contributions; or**
- **any combination of the above**

Where the statutory override is used, changes can be made to the scheme without the need for either a formal rule change or trustee consent.

The override is subject to restrictions. For example, you cannot use it to reduce employer contributions, or to increase the total amount of annual member contributions more than the annual increase in employer's National Insurance payments in respect of those members.

Trustees

Trustees will want to be sure that changes made by the employer using the statutory override are **properly communicated to members**.

Where contribution rates are changing, a **new schedule of contributions** will need to be agreed.

Trustees may also want to consider implementing a deed to reflect any changes, even though it is not strictly required where the override is used.

Will this be seen as an opportunity to close the scheme?**Employers**

Given the end of contracting out means employers will be looking at their DB scheme benefit and contribution levels, many see it as a sensible time to also consider the question of whether to close their scheme to future accrual.

Before any decisions can be made, it is wise to consider:

- how pension provision best serves your business objectives
- your particular workforce
- any other existing pension arrangements
- auto-enrolment requirements

If you do decide to make changes, remember you will need to carry out a full consultation and communication process with employees.

Trustees

If the sponsor decides to close the scheme to future benefit accrual, as trustees you should ensure:

- everything has been explained to members effectively - review employer communications on the subject where possible
- all benefits are calculated correctly at the point of closure
- appropriate arrangements are in place for the ongoing management and funding of the scheme

PSIT's view

Most of the few remaining open DB schemes are contracted out and are, therefore, likely to be affected by benefit and/or contribution level changes next year. Add to this the fact that agreeing contracted-out liabilities with HMRC may be time consuming and complicated to achieve, it is clear **pension trustees are going to be kept very busy** whatever decisions are made on future benefits.

It was expected that the end of contracting out would be the final nail in the coffin for many DB schemes. The current position with falling gilt yields and ever-increasing deficits mean this may well be the case. Of course, there are a limited number of industries where DB schemes are still the norm and other paternalistic sponsoring employers who will look at ways to help employees retain a DB pension option. Nevertheless, for many, **retaining a DB scheme is likely to be unaffordable** at a time when these employers are funding larger deficits.

If it is, we hope one result of this next round of scheme closures is a **more generous defined contribution (DC) provision for all employees**, and benefit packages that are more equal in value across all pension members. Fortunately, the pension flexibilities announced in the 2014 Budget are helping employers - employees have started to DC schemes in a more positive light!

Find out more

If you have any questions about how the changes to contracting out could affect your scheme, please contact Gillian Graham.



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This briefing is provided for general information only and is based on our understanding of the position as at the date shown. It should not be relied upon as advice on your specific circumstances.

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