

Leaders in pensions

The Abolition of Contracting-out: What can DB schemes do to offset the increased costs?

From April 2016, a single tier state pension will be introduced. This replaces the existing basic state pension and the earnings related state second pension. As a consequence of the abolition of the state second pension, DB contracting-out also ends on 5 April 2016.

For schemes which are currently contracted-out and open to accrual, the end of contracting-out means that both members and employers will pay higher, standard rate (Class 1) National Insurance contributions ("NI"):

- For members, this represents an increase from 10.6% to 12% of earnings between the 'lower earnings limit' (£5,824pa) and the 'upper accrual point' (£40,040pa)¹. Take-home pay will be reduced by the additional 1.4% NI; and
- For employers, this represents an increase from 10.4% to 13.8% of earnings within the same banding. In monetary terms, this could equate to up to £1,163 per employee, per year.

Although NI will increase, there is no automatic reduction to the level of benefits that a scheme provides. On the face of it, the cost of providing DB accrual will increase.

Offsetting the increased NI costs

For members, there is nothing they can do about the reduction to take-home pay. Members should be communicated with to explain the changes.

For employers, there are ways that the increased NI costs can be mitigated.

Legislation has been brought in to give employers a unilateral power to either increase member pension contributions or reduce future service benefits under their pension schemes, or a combination of the two, in order to offset the 3.4% increase in employer NI. The statutory power is for a limited time only and will not be available after 5 April 2021.

Statutory power

The increase in member contributions or reduction in accrual cannot be more than is necessary to cover the cost of the increased employer NI. The comparison between the increase in employer NI and the value of the proposed scheme changes needs to be calculated by an actuary appointed by the employer. It seems that calculations of the level of member contribution increase or reduction in accrual should be done on an aggregate basis, rather than a member by member basis – meaning it is possible that changes made using the statutory unilateral power could result in some members being worse off than others.

DWP's view is that an amendment made using this power will constitute a 'listed change' for the purposes of the consultation regulations, so employers will have to undertake a consultation exercise before making such changes.

Scheme amendment

The Government has stated that it does not expect employers to use the statutory power automatically – but only where the employer has no other choice (although the legislation does not reflect this policy and simply gives an employer the unilateral power).

¹ All figures are for the year to 5 April 2016.

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An alternative for employers is that they look to make rule amendments to benefit provision using their scheme's amendment power. This may require trustee consent and may be subject to other conditions depending on the terms of the amendment power.

Making changes using the amendment power potentially gives the parties a greater scope to offset the increased NI costs. Changes need not be limited to increased member contributions and/or reduced future benefits (and could include, e.g. increases to retirement age or a cessation of accrual) and the changes need not be an actuarial match to the value of the NI increase.

Related issues

The legal framework is complex and employers considering benefit changes in connection with the abolition of contracting-out should seek legal advice. They will want to consider the wider implications of any changes they are proposing, including consultation processes, employment aspects (e.g. contractual commitments or salary sacrifice arrangements), and communications. They will also need to access scheme data.

Action Points

Employers should:

- Calculate their increased costs associated with the abolition of contracting-out;
- Decide on any changes to benefit provision;
- Decide whether to use statutory or scheme amendment power.

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October 2015