The end of contracting-out
Employers must act now to understand costs and options

The ability of Defined Benefit (DB) schemes to contract-out of the State Second Pension will end from 6 April 2016, following the introduction of the single tier state pension. For employers with DB schemes which remain open to future accrual, this will increase National Insurance (NI) costs for employers and members as well as having other potentially significant implications on costs and liabilities. We expect most employers to want to take action to mitigate this increase in cost.

Discussions with Trustees and members can take time, particularly if significant changes such as closing the scheme to future accrual are planned. It is therefore important for employers to start planning soon to understand the cost implications and options. In addition, for employers expecting to engage with Trustees on Scheme Funding valuations over the next two years, it will be much more efficient to include the impact of the end of contracting-out in these discussions.

Employers should take the lead in discussing and implementing the necessary changes, as they will pick up the bulk of the additional NI cost if no action is taken. Employers and Trustees should take this opportunity to put schemes on a secure footing for the future, rather than just looking to mitigate the immediate increase in costs.

In this *Pensions Focus* we look at the implications of the abolition of contracting out for employers, in terms of costs, administrative issues and potential impact on scheme benefits, as well as the options available to employers to mitigate the impact.

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What does the end of contracting out mean for employers?

The headline impact of the end of contracting out is the increased National Insurance costs for employers and members. However this is not just a cost issue, communicating a reduction in take home pay to active DB scheme members will have a HR impact, and there are many other administrative implications for open DB schemes, many of which could affect schemes' benefits and liabilities.

Cost implications

Employers should make sure they have a full understanding of these potential costs before deciding on their action plan.

Higher employer NI costs

Employers will pay additional NI costs of 3.4% on earnings between the Lower Earnings Limit (LEL) and the Upper Accrual Point (UAP). Based on 2014/15 tax bands, **this could be as much as £1,000 per employee, per year.**

Member gross salary	Increase in employer NI
£15,000 p.a.	£314 p.a.
£25,000 p.a.	£654 p.a.
£35,000 p.a.	£994 p.a.
£40,000 p.a. and above	£1,165 p.a.

Reduction in member take-home pay

Members will also see an increase in NI contributions of 1.4% of earnings between the LEL and the UAP.

Member gross salary	Increase in employee NI
£15,000 p.a.	£129 p.a.
£25,000 p.a.	£269 p.a.
£35,000 p.a.	£409 p.a.
£40,000 p.a. and above	£489 p.a.

Other potential issues for employers

The cost of the additional NI is only one of a number of issues arising as a consequence of the ending of contracting-out. Some issues such as State Pension offsets and bridging pensions will also affect contracted-in schemes which remain open to accrual.

- **GMP reconciliation** – The ending of contracting-out brings a requirement to reconcile Guaranteed Minimum Pensions (GMPs) accrued between 1978 and 1997 with the National Insurance Contributions Office (NICO). This is a time-consuming process of comparing scheme GMP records with NICO's GMP records and resolving any discrepancies, a process which can take years and can lead to additional GMP liabilities if the scheme cannot prove that NICO's records are incorrect

- **GMP equalisation** – Once GMPs are reconciled, they will need to be equalised between males and females. This is a complicated process and will lead to an increase in liabilities. Employers should ensure that pragmatic solutions are used wherever possible to limit adviser costs
- **State pension offsets** – Many schemes have a deduction from pensionable salary to allow for State pensions. With the new single State pension, it is unclear how existing State pension offsets will apply. If they do not apply, this could significantly increase costs and liabilities within the scheme. The impact will be specific to each scheme depending on how its rules are written
- **Bridging pensions** – Many schemes provide a temporary pension from Normal Retirement Age in the scheme to State Pension Age. With the increases in State Pension Age announced at the same time as the ending of contracting-out, these bridging pensions may be paid for longer, increasing liabilities. It may, conversely, be necessary to introduce bridging pensions in order to facilitate retirement
- **Workforce planning issues** – The increases in State Pension Age (SPA) announced at the same time could create issues for workforce planning. Employers may find that employees can no longer afford to retire at 65, for example, when their State Pension doesn't come into payment until age 68 (in the mid 2030s) or later when SPA is linked to increases in life expectancy
- **Auto-enrolment certification** – Contracted out DB schemes did not need to be certified for auto-enrolment. From 6 April 2016 DB schemes continuing to accrue benefits will need to be tested against the 'test scheme standard' in order to be certified as qualifying schemes.

Statutory override power

The Pensions Act 2014 sets out the scope of a 'statutory override' power which will allow employers to make certain changes to their schemes to mitigate the increase in NI costs without Trustee or member agreement.

The Government is currently consulting on details of this power.

We expect that this statutory override power will be of use to certain employers, particularly where scheme rules or Trustees are particularly restrictive. The power can be used before 6 April 2016 if the effective date for the changes made is on or after 6 April 2016, meaning that employers intending to use this power can plan to complete the necessary calculations and certification in advance of the abolition of contracting out.

For most employers the statutory override power will not be sufficiently flexible for them to carry out more fundamental changes to their pension provision that they need.

The statutory override cannot be applied to 'protected persons'. Protected persons are individuals employed in formerly nationalised industries where legislation prevents employers from making changes to the pension benefits offered to those employees previously employed by the State.

The statutory requirement to consult with affected members will still apply to changes made under the Statutory Override if the change is within the category of 'listed changes' e.g. increasing member contributions.

Options for employers

The approach employers will take to addressing the increased costs will depend on many factors such as the size of the active DB membership, and the recent history of changes to the DB scheme.

- **Pay the additional employer NI** – For employers where the active DB members make up a small proportion of the total workforce, the simplest and cheapest option may be to simply pay the additional NI. Employers will still need to communicate to members the reasons for the reduction in their take home pay.

- **Minor changes to DB scheme** – Employers could make minor changes to DB schemes to offset the increase in employer NI. These could include:
  - Reducing accrual rates
  - Increasing retirement ages
  - Offsets to pensionable pay
- **Increase member contributions** – Employers could increase member contributions to offset the increase in employer NI. This is likely to be unpopular especially given that members will be facing their own NI increases.
- **Introduce Salary Sacrifice** – For those employers who have not yet implemented salary sacrifice for employee pension contributions, this could mitigate some of the NI increase.
- **Major changes to DB schemes** – Employers may wish to reassess the objectives of their pension provision given the changing nature of State provision and the recent Budget announcements on DC pensions. This could include targeting a lower level of pension saving for individuals given higher State pension (typically for lower earners), or re-assessing types of pension provision which have historically been less attractive. Cash balance schemes (DB schemes which guarantee a cash sum on retirement) may be more attractive in the new DC world (assuming that DB to DC transfers will be permitted).
- **Close DB scheme to accrual** – For many companies these increases in cost will be the final straw and they will look to close their DB schemes to future accrual. Generally this would be replaced by a defined contribution scheme. Employers may find employees to be more receptive to these given the recent Budget changes.

  Key considerations for these employers will be:
  - Seeking the agreement of the Trustees and members to close the scheme (if necessary)
  - Deciding what type of scheme to offer in future to affected members
  - Negotiating any compensation for affected employees
  - Consultation with employees and Unions
  - Implementing the closure to accrual before April 2016

Actions for all employers with open DB schemes

Even if employers decide not to change scheme benefits as a result of the ending of contracting-out, they will still need to:

1. Understand the additional NI cost for the employer and members from the ending of contracting-out
2. Assess the impact the State pension changes will have on State pension offsets and/or bridging pensions in your scheme rules, and associated changes in benefits and liabilities. Legal advice is likely to be needed to understand how the abolition of the Basic State Pension will impact your scheme
3. Allow for the additional NI costs and any changes to liabilities (due to State pension offsets and bridging pensions) in scheme funding negotiations and plans
4. Communicate the reduction in take-home pay to active members. It's important that communications around this explain what is happening and the link with members' eventual State pension benefits
5. Make allowances in the scheme's administration costs for a GMP reconciliation exercise, and subsequent GMP equalisation exercise

Actions for employers considering DB benefit changes/scheme closure

1. Understand the balance of power and scope of your scheme's power of amendment, can you make the changes you want to make? Consider whether the Statutory Override could be used
2. If continuing with DB, design a new benefit structure which better meets your wider needs as an employer
3. Engage and negotiate with Trustees to explain the impact of the changes on employer costs and scheme liabilities
4. Consult with members on proposed benefit changes
5. Implement benefit changes

How can PwC help?

- Assessing the costs of the ending of contracting-out
- Modelling the savings from various scheme modifications
- Sharing our experience of implementing benefit changes, and closing schemes to accrual
- Assisting with discussions with Trustees and employees
- Drafting communications to members
- Providing a pragmatic and cost effective solution to the GMP equalisation challenge

For a further discussion on any of the issues raised in this bulletin, please contact your usual PwC pension adviser or:

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