Health Professions Council
Finance and Resources Committee Meeting – 20th November 2006

PENSION FUND UPDATE - PUBLIC PAPER

Executive Summary and Recommendations

1. Introduction

Following the receipt in mid October of a Pension employer letter from Capita (formerly FPS), our pension fund managers outlining changes to the scheme, we have prepared a paper outlining some implications for HPC. A similar letter was sent out on 6th November by Capita to HPC employees and ex-employees who are members of the fund.

2. Decision

The Committee is requested to :

- **note the issues and,**
- **approve the appointment of a qualified independent advisor to advise HPC on the next steps regarding HPC's existing pension fund and on providing an attractive employee pension fund in the future.**

3. Background information

3.1 Flexiplan Scheme

HPC offer permanent employees who have successfully passed their probation period the opportunity to join the HPC pension scheme, namely the Federated Flexiplan No 1-6441 scheme. This scheme is administered by the Capita Group and in June 06 was described by the Operations Manager of Capita as "a relatively unusual, centralised, hybrid Defined Contribution/Defined Benefit scheme." HPC, the employer, puts in 16.5% of employee base salary and employees contribute 3%. In addition, employees can contribute up to 15% additional voluntary contributions.

3.2 Scheme Valuation

In June 06, at the request of the auditors, we requested a Pension Scheme Actuarial Valuation from Capita, as at 31st March 2006. The Capita Operations Manager responded by saying that "there are a number of complex issues to consider with the scheme, particularly as new regulations have required significant changes to the valuation principles previously applied. Before the valuation can be concluded, there are a number of points that require clarification, both from the new Pensions Regulator and Legal Advisors. Until these questions have been answered, we will be unable to provide you with the details… It is very difficult to be specific over how long it will take to resolve the outstanding issues."

At the time of writing no valuation has been received. We only received the 31st March 2005 Valuation Report on the 19th of October 2006.

3.3 Scheme changes

In mid October 2006, we received a letter from Capita Trust Company[1], a subsidiary of the Capital Group of companies, outlining various changes affecting the pension scheme that HPC currently uses – see attached Appendix.

In late October, at the recommendation of a member of HPC's Audit Committee, we approached a partner (Nigel Hacking) at Barnett-Waddingham, a firm offering pension fund consultancy services. We asked Nigel to examine HPC's pension position and obligations relating to the existing scheme and to recommend a suitable approach going forward, regarding the existing and potential pension fund members.

The partner concerned is a qualified actuary and an Associate of the Pensions Management Institute. He has wide experience providing actuarial, investment consultancy and general consultancy advice to clients ranging from UK PLC's to small companies. He has also acted as an expert witness in a number of pension litigation cases.

Nigel attended the 3rd November pension fund briefing by Capita (referred to in their October letter) on HPC's behalf, to gather further information relevant to commence making an informed assessment of our pension position and options. His report on the 3rd November meeting is attached as an appendix.

Finally, we notified our auditors of the issues and the HR Director is examining employee contractual issues relating to this issue.

3.4 Observations

Based on section 7.2 in the Capita letter attached, if HPC were to reduce its contribution *to the Flexiplan scheme* (but still continue to meet its employer commitment of 16.5% funding to contributing employees of the scheme), the annual cost to pay Capita would drop from approx £180k to £4.2k, with the balance of the employer obligation going to fund some other pension scheme for existing and future pension scheme members. It would only be worth funding another scheme providing the economic benefits of the new scheme to members could be reasonably expected to outweigh those of the existing one.

It is likely that if HPC decide to divert future contributions (other than the minimum contributions outlined in section 7.2) into a more attractive pension fund, other member organisations of the existing Capita Flexiplan scheme (approx 150 employers) may well take a similar course of action. Whether Capita have fully factored in the impact of such actions on future Flexiplan scheme annual returns is unknown.

3.5 Next Steps Proposed

[1] We ran a credit check on Capita Trust Co Ltd. The credit opinion was that Capita Trust Co is a very low risk company, with no unpaid accounts or legal notices & judgments. We also ran a credit check on the parent company, The Capita Group PLC. The credit check result for Capita Group was that it is a very low risk company. Capita Group Interim Financial Results for the 6mths to 30th June 06 show strong and diversified financial performance also.

According to its website www.capita.co.uk, The Capita Group currently administers over 350 occupational pension schemes in the UK & Ireland and administers pension payments on behalf of over 3.2M people.

Following approval, we will commission a report from the Pension consultant to be brought back to the Committee, outlining HPC's options and making a recommendation going forward.

We will brief HPC employees who are members of the current scheme as and when the issues are resolved.

We have invited the Capita Pension Operations Manager to visit HPC in early December 2006 to provide HPC staff (some 36 members of the scheme) with an update on the current pension scheme and answer questions staff members might have on the October letter sent to them by Capita Trust Co Ltd.

3.6 Pension Fund Administrative Charges

As a cost to HPC, are they currently excessive? There are two aspects to this, is the cost excessive by industry standards and does the benefit received justify the cost charged? Regarding the first aspect, at present we pay about £13k per yr to Capita to cover pension scheme administration, accountancy and trusteeship services. We asked Capita for definitions of each of these services, but were not yet provided to us, at the time of writing.

We estimate Capita have very approximately, £1M of contributions from HPC employer and HPC/CPSM employees and ex-employees dating back to when the Flexiplan scheme replaced the old CPSM scheme. This equates to an annual administration charge of approximately 1.3% of funds under management.

As a comparison, Rensburg Sheppard verbally said their investment fund administration charges were approx 1% of the funds managed per annum[2]. Typically, Pension fund management charges are higher than Investment fund management charges, as Actuary costs are necessarily incurred to value the Pension obligations and need to be recouped. We propose getting the pension consultant to provide a wider industry benchmark on annual pension administrative charges in the report commissioned.

Does the benefit to Flexiplan Pension Fund members justify the cost charged to HPC? Given the proposals in the October letter from Capita and a guaranteed annual return of only 2%, prima facie, no.

4. Resource implications

Nil

5. Financial implications

- For the existing Flexiplan pension scheme, an annual Levy fee, yet to be determined, payable by the employer (HPC).
- Pension consultant cost including producing a report on HPC's pension fund options and making a recommendation going forward = £1.8k
- Consultant cost to set up a new pension plan = £12k

[2] HPC actually pays about 0.5% of the funds managed in administration charges to Rensburg Sheppards on investments managed - approx market value of the investments at the time of writing is £1.75M.

- Cost to maintain an ongoing role with the new plan (by the pension advisor) = £2.9k
- Cost to verbally update HPC employees (by the pension consultant) of the changes = £1.8k
- Potential cost, if HPC legal advice sought and/or legal action is pursued.

6. Background papers

Nil

7. Appendices

- Consumer information on pensions from the Financial Standards Authority (see below)
- Letter from Capita Trust Company Ltd
- Email from Nigel Hacking on the 3rd November Capita presentation

8. Date of paper

8th November 2006

Appendix

Consumer Information on Pension schemes, from the Financial Services Authority website www.fsa.gov.uk

1. Pensions

(a) The main types of pension

There are three main types of pension

Occupational salary-related schemes

Some employers set up these schemes to provide pensions for their employees based on the employee's salary and pensionable service. They are sometimes called 'defined benefit' or 'final salary' schemes. The employer contributes to the scheme and there are trustees to look after scheme members' interests. You can only get salary-related pensions through your employer.

Occupational money purchase schemes

Some employers offer these pension schemes - they are sometime called 'defined contributions schemes'. They do not provide a pension based on your salary or pensionable service. Instead, they build up a personal pension fund that you convert into an income when you retire. Usually, the employer contributes to the scheme and there are trustees to look after scheme members' interests.

Stakeholder and personal pensions

These are also money purchase pensions and are the most popular choice for

people who arrange their pensions privately. Financial institutions (insurance companies for example) usually run these schemes. We call them 'pension providers'.

Some employers also offer stakeholder and personal pensions to their employees.

(b) Money purchase pensions

These pensions are all **money purchase** pensions:

- Occupational 'defined contribution' pensions provided by some employers;
- Stakeholder and Group Personal Pensions offered by some employers;
- All the pensions available to you privately.

Money purchase pensions work by building up a pension fund using your contributions (and your employer's contributions if they make any), plus investment returns and tax relief. It helps to think of money purchase pensions as having two stages:

Stage 1: The fund is invested, usually in stocks and shares and other investments with the aim of growing the fund over the years before you retire.

- You get tax relief on your contributions;
- Your fund grows free of income tax and capital gains tax;
- You may be able to choose the funds to invest in;
- Your employer may contribute if it's a work-based pension;

Stage 2: When you retire, you can take a tax-free lump sum from your fund and use the rest of the fund to buy an annuity (an income for life). This is why they are called 'money purchase' - you are swapping your fund for a regular income for the rest of your life.

The amount of pension you'll get at retirement will depend on:

- how much you pay into the fund;
- how much your employer pays in (if anything);
- how well your invested contributions grow.
- the charges taken out of your fund by your pension provider;
- how much you take out as a tax-free lump sum;
- 'annuity rates' at the time you retire; and
- the type of annuity you choose.

2. Pensions

(a) Annuities - income from your pension

An annuity is a special type of investment that will pay you an income for the rest of your life, however long you live. Buying an annuity means you convert your money purchase pension into an income for life.

Money purchase pensions include:

- a **personal pension**;
- a **stakeholder pension** scheme;
- a **group personal pension plan** arranged through your employer;
- a **retirement annuity contract** (similar to a personal pension but sold before July 1988 when personal pensions first became available);
- a **free-standing additional voluntary contribution (FSAVC)** scheme
- some **Section 32** policies

If your 'pension pot' is in an employer's occupational money purchase scheme (sometimes called a 'defined contributions' scheme), you or the trustees of the scheme will have to buy an annuity when you retire. The same applies to an additional voluntary contribution (AVC) scheme that builds up your own investment fund on top of an employer's scheme.

What is an annuity?
Buying an annuity usually means that you exchange your pension fund for a lifetime income. You might think that this is something of a gamble - and you would be right. There are winners and losers, but all benefit from the knowledge that they'll have an income for life - no matter how long that might be.

Insurance companies sell annuities. They calculate the annuity rates they offer people by taking account of the fact that some people will live longer than others. Obviously people who live longer than average will take more from their annuity than, for example, someone who dies three or four years after retirement. Those people who die early subsidise the annuity rates for those who live longer. Insurance companies adjust rates because average life expectancy is rising and people are living longer. Interest rates also affect annuity rates.

Letter from Capita to HPC

9th October 2006

Dear Employer

Federated Flexiplan No, 1 Pension Scheme (the Scheme) Actuarial Valuation

We are writing to you in connection with the latest actuarial valuation of the Scheme.

1. **Background**

1.1. The Scheme is a defined benefit occupational pension scheme, which provides hybrid benefits. A Triennial Actuarial Valuation was due to be completed by the spring of 2006. However this was delayed because it has been necessary to take legal advice as to the operation of the Scheme rules within current pension legislation. The Pensions Regulator has been advised of the delay. The valuation is now nearing completion. It will then be necessary to carry out a further valuation as at 31/03/06 in accordance with the new statutory funding basis required by recent legislation, which is called the Scheme Specific Funding Standard.

1.2. The results of the valuation have important ramifications in terms of the funding of the scheme and the benefits payable to its members.

2. **The Scheme benefit design**

2.1. The Scheme has an underlying Pensions Capital provision which is, in effect, a defined lump sum available to secure benefits at retirement. A Member's Account is established and, a guaranteed rate of interest to contributions paid on a member's behalf is added to the Member's Account. This Member's Account, together with the guaranteed rate of interest, is the Pensions Capital. The guaranteed rate of interest on pension contributions is at the rate of 2% per annum compound for the period since 1 April 2003 and 4% for the period prior to this.

2.2. Up until recently all retirement benefits for employees still in service at retirement have been paid with reference to a members target benefits, based on pensionable service completed and salary, rather then the Pensions Capital fund guarantee. Actuarial advice confirmed that this was possible. Following the last Scheme valuation, the target benefits moved to an average salary rather than the final salary target basis that had operated prior to this.

3. Pension Scheme Funding Issues

3.1. In common with many pension schemes a number of factors have caused difficulties in the funding position of the Scheme. The difficulties include:

3.1.1. Investment returns due to market conditions being below what was assumed in Actuarial valuations.

3.1.2. Scheme "maturity" as members reach retirement and the balance of membership moves in favour of retired members and liabilities for pensions in payment.

3.1.3. Prolonged low interest rates have affected Bond yields. The falls experienced in Bond yields have in turn increased the costs of buying annuities.

3.1.4. Continuing Improvements in life expectancy, which have a similar effect on annuity costs.

4. Regulatory Changes

4.1. There are two key regulatory changes which have also impacted the Scheme:-

4.2. previously, defined benefit occupational pension schemes had to comply with the minimum funding requirements of the Pensions Act 1995 (MFR). MFR has been discredited as it did not give a true reflection of the funding position of a scheme. It has now been abolished and has been replaced with the scheme specific funding standard, introduced by the Pensions Act 2004. This has the effect of raising the bar on minimum pension scheme funding.

The current status is that, whilst the Scheme is in surplus on an MFR basis, which tests Pensions Capital rather than target benefits, it is not clear whether it will meet the scheme specific funding standard. The Scheme specific funding standard valuation is underway. It is clear that the assets are insufficient to meet the target benefit.

4.3. until

a. June 2003, in the event that a defined benefit occupational pension scheme wound up; or
b. September 2005, an employer ceased to participate in a defined benefit occupational pension scheme,

The liability of an employer was, in general terms, the extent to which either the scheme or the employer's proportion of liabilities in relation to the scheme did not meet MFR. A crucial change has been the requirement to provide for full benefits on an annuity basis on wind up and on an employer ceasing to

participate in a scheme (which is considerably more than the MFR). This development has the effect of significantly increasing the liability on all employers who operate a defined benefit occupational pension scheme. This is in accordance with section 75 of the Pensions Act 1995.

5. **Challenges and actions**

5.1. These developments create a number of challenges. The product provider (FPS Group Limited which is owned by Capita Business Services Limited) has taken legal advice and sought Counsel's opinion, which it has shared with the Scheme Trustee (Capita Pension Trustees Limited) on how to interpret the Scheme rules in these circumstances.

5.2. The legal advice provided is that the Scheme is a defined benefit Scheme.

5.3. Legal and Actuarial advice has lead to the decision by the Trustee that retirement benefits can no longer be paid out in accordance with Target benefits. This change is made with effect from 10th July 2006. Instead members will be paid the benefits secured by the Pensions Capital amount. The Pensions Capital is in effect a retirement fund, which can then be used to secure a Compulsory Purchase Annuity from an insurance company.

5.4. This will impact on pensions for any member who has not yet taken benefits in that the member's Pensions Capital is unlikely to be the same as the target benefits.

5.5. This will include also any member who has received a quotation before 10th July but for whom benefits have not gone into payment.

5.6. It is now necessary to carry out a further actuarial valuation on the new Scheme Specific Statutory Funding Requirement basis. In order to meet the requirements of this basis the Trustee needs to come to an agreement with all sponsoring employers on the assumptions to be used for the future funding of Pensions Capital. In the event that agreement cannot be reached the Pensions Regulator will impose the basis.

5.7. The Scheme will probably need to participate in the Pension Protection Fund (PPF), which is the new requirement to pay levies to a central fund. The PPF pays in certain circumstances, benefits on the insolvency of a solvent participating employer. In the past The Pensions Regulator had been of the view that the PPF did not apply, however this is now open to question.

5.8. On the assumption that PPF will apply, costs to employers may increase to the extent of the PPF levy.

5.9. Pension scheme funding challenges are unwelcome for any employer, but particularly those in the Charities, Care and education sectors from which so many Flexiplan employers are drawn.

6. **Key Points**

6.1. There are some key points that we should draw to your attention at this stage:

6.2. Whilst the Scheme cannot continue to provide the Target Benefits it is roughly in balance in providing the Pensions Capital, which is the guaranteed benefit. Subject to the results of the Scheme Specific Funding valuation, it seems unlikely that employers continuing in the Scheme will have to pay any significant amounts towards supporting the Pensions Capital, which is not the case with most guaranteed benefit (e.g. final salary) schemes.

6.3. Any employer who decides to cease including active members in the scheme will need to take great care and take advice as there is very real risk that this will trigger a legal requirement to make an immediate and substantial contribution to the Scheme. As mentioned this arises as a result of Section 75 provisions of The Pensions Act 1995 as recently amended.

7. **Next Steps**

7.1. Once the actuarial valuation report has been finalised you will be sent a copy.

7.2. In order that a section 75 debt is not triggered you may continue to pay contributions at the existing level or reduce them to a minimum of £10 per member per month but see comment above about the risk of ceasing contributions completely. In addition you will be required to maintain death in service benefit insurance premiums. We would ask that you advise us in advance if you do decide to reduce contributions.

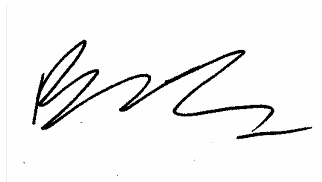
7.3. Once the Scheme Specific Statutory Funding valuation has been completed any extra contributions that may be required to support the Pensions Capital can be determined. The present indication is that these will probably not be significant but the position is sensitive to the assumptions used, which have to be agreed between the Trustee and the employers. A consultation exercise on these assumptions will commence shortly.

7.4. We suspect that many employers will wish to discuss the impact of the funding position. Participating Employers of the Flexiplan 1 scheme are many and varied and individual meetings are impractical. We are therefore arranging a group meeting for all interested employers in London on 3rd November. You will be sent further details under separate cover.

8. In the meantime we attach a copy of the Announcement from the scheme Trustee to members which is being sent directly to members.

Ahead of the group employer meeting if you have any queries they should be addressed to us in writing.

Yours sincerely



David Braithwaite
Capita Pension Trustees Limited

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Email from Nigel Hacking to Simon Leicester, dated 6th November 2006 on Pensions

Simon,

Some feedback from Friday's meeting with Capita, plus our fee estimates as requested.

1) Feedback

The presentation was delivered by;

From Capita: Paul Sturgess (Operations Director of the Benefit Consulting & Actuarial division) and Peter Barnard (Actuary to the Plan)
From Capita Trustee Company: Jonathan Vickers (MD) and David Braithwaite
From Addleshaw Goddard: Jo Radcliffe, partner Manchester office.

There were about 20 employers represented at the meeting and a similar number at the morning meeting. They are planning to hold a 3rd and final meeting, on 7 December I think they said.

There are about 150 employers currently participating in the Plan and a further 250 approx who no longer participate but have left liabilities in the Plan. The current employers are now responsible for these "orphaned" liabilities of former employers. They are checking to make sure no debts are due from these former employers, but it seems most unlikely that there will be any.

As we know, the Plan has moved to essentially a defined contribution basis with a guaranteed minimum investment return of 2% per annum (4% per annum for money invested before 1 April 2003). They are still considering the investment strategy and so it is not yet clear how the funds will be invested going forwards. They explained that it would probably be managed on a with-profits style, i.e. declaring annual interest and then a final bonus addition at retirement.

They explained the 3 options for the current participating employers:

1) Continue to fund for the target benefits. Each employer adopting this route would have its own sub-fund within the Plan and would have to pay its own legal & actuarial costs in setting up and running the sub-fund. They thought that this approach would be prohibitively expensive for most, if not all, employers (although they didn't provide any details of the cost).
2) Accept the change to the defined contributions and continue paying contributions at whatever rate the employer decides. They emphasised the need to consider contracts of employment and take legal advice and consult with staff over the change.
3) Provide future benefits under a different pension plan, eg a group stakeholder scheme, or if possible by participating in another centralised scheme. (Again, contracts, legal advice & consultation would need to be considered.)

They said that they had already sent explanatory letters to all deferred members and that they would be issuing letters to current employee members immediately after the meeting. They said these would be sent directly to the employees' home addresses.

They said that the annual benefit statement would be issued before the end of 2006 and would show the value of the member's Capital Account and an illustration of the pension at retirement age. They said that these illustrations will show pensions that could be up to 80% less than the

previous target pensions shown on last year's benefit statements. (Concern was raised about members very close to retirement, or even members who had delayed drawing benefits after retirement age, but Capita explained that there would be no special treatment.)

They emphasised on several occasions the importance of "section 75" debts. This debt would be triggered if an employer ceases to participate in the Plan and would represent its share of the deficit (assessed as £9.5m as at 31 March 2005, but likely to have worsened since then), including its share of the deficit relating to the orphaned liabilities. To avoid triggering this debt, you would need to keep at least one member contributing to the Plan (although you would need legal advice on this point), at the minimum set by Capita of £10 per month.

If a member wishes to transfer his benefits out of the Plan, the transfer value payable would be the full value of the Capital Account.

There was some hostility towards Capita at the meeting, but not as much as I had expected. There was however a suggestion of the employers collectively seeking legal advice on whether to take action against Capita.

2) Fee estimates

There are several aspects where you may wish to use our services, including:

a) New Plan
To assist HPC in deciding the form of future pension provision from the options of (i) FlexiPlan, (ii) a different centralised scheme and (iii) a new HPC pension plan, including correspondence and attending meetings with HPC, I estimate our fees would be £1,500, plus VAT. This is a very rough estimate, since it depends on whether another centralised scheme is available (I have assumed that one is not available for the purpose of this fee quote, although included some allowance for researching the availability).

If the decision is taken to set up a new HPC pension plan: to recommend the type of plan, the provider and contribution structure, investment options etc and to set-up the new plan (including plan booklet, joiners pack etc), I estimate our fees would be £10,000, plus VAT. We would also retain an ongoing role with the new plan, with estimated fees of £2,500, plus VAT, a year. We could take some commission to cover some of these set-up and ongoing fees, but with higher charges on members' pension funds.

b) Existing Plan
If the decision is taken to stay with the FlexiPlan in its new form, then there would not be any fees. However, it you decide to set up a new HPC pension plan, members will have the option of leaving their existing fund in the FlexiPlan or transferring to the new HPC pension plan, or to any other pension arrangement. Normally, we would assist in making members aware of the options and recommend they take independent financial advice (we would not normally provide the individual advice, partly because we may not be seen as independent by the members – since we are advising the employer – but also because employers do not normally wish to cover this expense, which can be quite significant because it requires full financial "factfinds" on each member, say £500 plus VAT per member.)

c) Communication
To draft communications to staff on the changes and attend one staff meeting, I estimate our fees would be £1,000, plus VAT.

There could be other work that may arise, particular if legal advice and/or legal action is pursued.

I hope that this is sufficient for the time being and I look forward to hearing from you in due course.

Regards,

Nigel.

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