



# Defined contribution defined: redrawing the DC/DB line

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Importance ★★★★★☆

## More pension schemes will now count as defined contribution (DC) and escape the defined benefit (DB) funding requirements.

The Court of Appeal has decided\* that a scheme can be DC under pensions legislation even if there can be a mismatch between its assets and its liabilities, or if the final benefit depends on an actuarial calculation.

The only previous case to explore the distinction between DB and DC schemes in detail\*\* had taken a purist line: to be DC, benefits had to be the direct product of the contributions paid in and the real return they earned. Many DC schemes operate like that. But others include features that beg the question whether they count as DC under the legislation.

### Category matters

DB is the default categorisation. For the Pensions Acts, all schemes are DB unless they fall within the definition of a DC scheme.

Schemes categorised as DB are subject to scheme specific funding, the s.75 employer debt and accounting obligations, to name a few. So it is critical which side of the DC / DB line a scheme falls.

### The scheme

Originally, the scheme in the recent case was DB. Later it became hybrid when two new tiers were added that were thought to be DC. In one, DB and DC benefits were in a common fund for which the employer had a balance of cost funding obligation. The DC accounts and the rates of return on them were purely notional.

In the other tier, there was a guarantee that the benefits would not be lower in value than a specified DB benefit.

The scheme was contracted out initially on the GMP test and later through protected rights. In 2003 it began to wind up with a large deficit. The PPF did not yet exist.

The trustees needed to work out what benefits to pay to different categories of member under the statutory priority order that applied at the time. But before doing that, they

had to establish which, if any, benefits were DC because the legislation on winding up ring-fenced DC benefits so that they could be paid in full.

### DC benefits defined

This is the statutory definition of DC (or “money purchase”) benefits:

*“...benefits the rate or amount of which is calculated by reference to a payment or payments made by the member or by any other person in respect of the member...”*

### Seven questions

The Court of Appeal began by making clear that it would not be taking a purist line. Evidently, it saw a policy need to widen the range of schemes that would not be subject to the DB legislation.

The court then answered seven specific questions.

**Q1** Where members’ contributions were credited with a notional investment return, were the benefits DC? The notional return opened the possibility of a mismatch between assets and liabilities because GMP was the first call on these assets.

**A** Yes, because the calculation of the benefits was nonetheless “by reference to” (see the definition) the contributions.

**Q2** Normally, a member’s account was converted into an annuity within the scheme. Was the result a “DC benefit” despite the conversion?

**A** Yes, the member’s income was calculated “by reference to” the size of his or her account, not by reference to the actuarial calculation.

**Q3** Where GMP was the first call on an account, were the benefits still DC?

**A** Yes, because GMP was a “notional pension corresponding to what would be paid under... SERPS.

The function of GMP is to identify the minimum below which the pension calculated “by reference to” contribution payments... may not fall.”

**Q4** Where there was a guarantee that the benefits derived from an account would not be lower in value than a specified DB benefit, were the benefits still DC?

**A** Yes; even though there was a floor to their value, the benefits were still DC.

**Q5** For members entitled to GMP, were DC benefits accrued *after* 5 April 1997 (when GMP contracting out ended) such that they would only be paid if they exceeded the value of a salary related benefit? Or, in the language of the legislation, were they “underpin benefits”? If so, they would not be ring-fenced but would be subject to the statutory priority order and to abatement because of the deficit.

**A** No, only DC accrual *before* 6 April 1997 was an underpin benefit that fell under the statutory priority order.

**Q6** Were protected rights ring-fenced as DC benefits?

**A** Yes, despite the express reference to them in the statutory priority order. (This was a legalistic issue about the relationship between the priority order and the regulations that modified it in the case of a hybrid scheme.)

**Q7** Members chose what level of contributions to pay to their accounts and the employer made matching contributions. Were benefits arising from matching contributions “derived from the payment by [the] member of voluntary contributions”? If so, they had top priority along with benefits derived from members' own voluntary contributions.

**A** Yes, because the payment of contributions by the member prompted the employer's contributions. And also because this reading was more consistent with the policy behind the legislation of giving a high level of protection to voluntary additional saving. This answer remains pertinent to schemes that have begun to wind up since the statutory priority order was revised with the introduction of the PPF.

### Comment

Many schemes will welcome this deliberate widening of the concept of a DC scheme. They will now receive much lighter treatment under the Pensions Acts than if the court had followed the stricter line in the KPMG case.

The court was careful not to attempt an exhaustive characterisation of a DC scheme. This leaves the door open to schemes with similar but different features to argue that they too fall into the DC category.

Any scheme that thinks it now counts as DC should take advice. (There is more detail to the court's decision than is outlined in this note.)

The Department for Work and Pensions took part in the case because of its important policy implications. These include funding, the employer debt and PPF protection.

The DWP's intervention helped the court test the boundary between DC and DB. The result is a decision in which schemes can have considerable confidence. But it may not be the last word. The wide-ranging implications of the decision could prompt the DWP to take the issues further, either in the courts or with changes to the legislation. Any such developments are unlikely in the short term, however, because it will take the DWP some time to work out the full repercussions.

\* *Houldsworth v Bridge Trustees* (previously known as *Bridge Trustees v Yates*).

\*\* *AON v KPMG*