

Statement from The Pensions Regulator to trustees, scheme administrators and employee benefit consultants of hybrid schemes

Understanding and managing your hybrid scheme

Introduction:

The importance of hybrid schemes

Occupational pension schemes that feature 'hybrid' structures – combining both defined benefit (DB) and defined contribution (DC) benefits – can be complex. To manage such hybrid schemes effectively, it requires trustees and their advisers to have an in-depth understanding of their scheme structure and the benefits it offers. Trustees need to exercise good governance over their schemes by having in place robust systems and processes to ensure the assets attributable to each benefit type are separately identifiable.

The aim of this statement is to help trustees and their advisers understand the risks that can arise in hybrid schemes and to take action to mitigate them. The statement includes a series of checklists which summarises the actions which trustees, administrators, employee benefits advisers, and others, should take to make sure they are able to properly manage their scheme.

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'The scheme is a DB, which contracts out, DC with a GMP underpin, and a mishmash of others.'

A trustee describing their hybrid structure in response to the regulator's research, August 2011

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The term 'hybrid scheme' is used widely within the pensions industry. For the purposes of this statement, hybrid schemes are defined as those that include a combination of DB and DC benefits within the scheme. Examples of hybrid schemes include:

1. Separate DB and DC sections under 1 trust
2. DB scheme with a DC underpin, eg a scheme that will pay a member the better of their DB or DC benefit
3. DC scheme with a contracted out element on a DB basis or vice versa
4. DB schemes with a DC top-up.

Understanding the hybrid landscape

With the introduction of automatic enrolment from 2012 and several million more people expected to be contributing into qualifying schemes, we anticipate that the number of DC members in hybrid schemes will increase. It is therefore important those running hybrid schemes properly understand and mitigate the risks which can arise in such structures.

The complexities and risks of hybrid benefits were highlighted in the recent Supreme Court case, *Houldsworth v Bridge Trustees* and the Secretary of State for Work and Pensions. In this case, it was unclear whether certain benefits were money-purchase (DC) or DB in nature. This scenario is by no means unique and leads to confusion over identification and payment of benefits. We will return to this issue later. The Department for Work and Pensions (DWP) has since stated their intention to revise the legislation which defines money-purchase (DC) benefits.

We recently carried out an independent survey of 150 hybrid schemes¹ to better understand the types of hybrid schemes, administration and governance arrangements and other risk areas for hybrid schemes. The key results from this survey are set out in this statement and in our attached **checklists** for trustees, administrators and employee benefit consultants.

From November 2011, there will be additional questions included in our scheme return (for DB and hybrid schemes) allowing us to understand and monitor hybrid schemes more effectively. We will rely on the information given to us to determine our future regulatory approach to hybrid schemes. It is therefore important that trustees are able to answer these questions correctly.

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'It is... important those running hybrid schemes properly understand and mitigate the risks which can arise in such structures.'

¹ The Pensions Regulator's hybrid pension scheme survey 2011

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Potential risks to members

The risks that arise if hybrid schemes are not understood and managed, along with our concerns, are below.

Lack of governance

To run a hybrid scheme, trustees must ensure that they have the appropriate understanding and governance over the different benefits offered to their members.

Our research highlighted the risk that trustees may be spending insufficient time on the DC element of their hybrid scheme – 65% of trustees spend less than 25% of their trustee meetings on DC specific matters. For good governance, it is essential that appropriate time is spent on the different benefit elements within a hybrid scheme.

Unclear and incorrect member communication

The complex nature and structure of hybrid schemes can cause confusion around the type of benefits offered to members. In particular, it can potentially lead to member communications being unclear or misleading and members' benefits being calculated incorrectly.

The survey we conducted showed that trustees were not always able to describe the different benefit elements offered by their schemes. This could result in unclear information being provided to members, which could, in turn, impact members' expectation and understanding of the nature of their retirement benefits.

We have concerns that trustees are not aware of the statutory information that must be communicated to members. Only 73% of the schemes surveyed stated that they provide **statutory money -purchase illustrations** to their DC members. Trustees must ensure that communication to members is clear and information provided to members is in line with legal requirements.

Incorrect benefits and funding levels

There is a risk that members' benefits and scheme funding levels could be calculated incorrectly where DB and DC assets are mixed together and are not separately identifiable – eg where assets are combined in the same bank account or invested in the same investment funds.

The findings from our survey showed that over 50% of hybrid schemes were using the same bank account for both DB and DC monies. A high proportion of schemes could not, at any given time, identify which monies belonged to which members of the scheme.

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'To run a hybrid scheme properly, trustees must ensure that they have the appropriate understanding and governance over the different benefits offered to their members.'

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Incorrect benefits and funding levels continued..

The survey also showed that cash flow statements do not contain sufficient detail at DC member level to avoid mixing DB and DC members' assets. This implies administration and governance over cash flow processes are ineffective. If trustees cannot distinguish between cash flows attributable to DB and DC benefits, it becomes difficult to segregate the different benefits when benefits are paid, or when a scheme goes into wind-up.

Our survey also showed that trustees and their advisers may not have sufficient knowledge of the actions which should be taken on winding up a scheme. In the event of a wind up, the DC benefits should be separated from DB benefits. Non-money-purchase benefits are subject to a legal priority order for payment. These rules are complex and depend upon a number of factors. Our survey demonstrated that trustees' knowledge in this area is weak (22% of respondents did not know which benefit type would be paid first to their members). Identification of DC assets will depend on the ability to separate the money-purchase assets within the scheme – and will clearly be more difficult where there has been mixing of benefits within 1 account. Trustees who are unable to separately identify their DB and DC assets risk breaching their duty of care to their members.

Pension Protection Fund (PPF) protection is available to DB members. Just under 50% of respondents stated that they were paying PPF levy for all members, including DC members. Whilst there are many valid reasons for schemes to pay the PPF levy for DC members (ie hybrid schemes with underpins), trustees should verify with their scheme actuary or advisers that the correct information is submitted for levy purposes. Of the schemes we identified which paid PPF levy for DC members, approximately 60% had taken advice on whether or not the PPF would offer protection to these members.

Inappropriate investment strategies

A third of respondents use similar investment strategies for both the DB and DC sections. Additionally, 70% of respondents used the same individual adviser for both the DB and DC elements of the scheme. The DB investment risks are borne by the employer whilst DC members bear their own investment risks. Inappropriate investment strategies and insufficient investment challenge by the trustees could impact DC members directly.

Requirements on retirement options

There is a legal requirement under the Finance Act 2004, for trustees to offer the **open-market option (OMO)** to their DC members upon retirement. Our findings showed that only 73% of the hybrid schemes surveyed are doing so. We expect trustees to fully comply with this requirement.

'There is a legal requirement under the Finance Act 2004 for trustees to offer the open-market option (OMO) to their DC members upon retirement'.

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Next steps

We will continue monitoring hybrid schemes and investigate further situations where we believe benefits offered to members are inaccurate, confusing or being misrepresented to members.

If you are a trustee and are unsure of what actions are appropriate to your scheme, you should speak with your advisers to gain assurance that you understand the structure and governance of your hybrid scheme, along with the benefits you offer to your members.

To help trustees, their advisers and scheme administrators reduce the risk to members in hybrid schemes, we have developed individual checklists:

- **Checklist for action by trustees** (page 6)
- **Checklist for action by scheme administrators** (page 7)
- **Checklist for action by employee benefit consultants and other advisers** (page 8)

These checklists should be considered and acted upon to ensure that hybrid schemes are understood and managed properly.

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| Checklist for action by trustees | | Please tick ✓ |
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| 1. | Ensure you understand the different members' benefit entitlements. This should also include understanding the level of protection offered to each type of scheme member. | |
| 2. | Review your governance arrangements over the different benefit elements to ensure that they are sufficiently rigorous. Ensure adequate time is spent on DC specific matters, including assessing the need for a trustee committee to address DC matters. Read the statement on the role of trustees in a DC scheme which clarifies our expectation of trustees. | |
| 3. | Check the robustness of your scheme's internal controls over the different benefit types. This should include regular monitoring of administrative processes and management information. The controls in a hybrid scheme should be sufficient to address the individual DC members' risks eg regular reconciliation of assets and cash flows at DC member level. | |
| 4. | Assets for DB and DC elements should be clearly identifiable and if possible, separately held. Scheme accounts should separately show asset and liabilities allocated to individual members and those which are not. | |
| 5. | Understand the safeguards available for the different assets against losses arising from operational, fraud and insolvency failures and how tracing rules would apply for mixing DB and DC assets. | |
| 6. | Assess your investment advisers' and third party administrators' skills on DB and DC benefits separately, recognising that different skill sets are required for each benefit element. | |
| 7. | Check that the correct information to calculate the PPF levy is provided on the regulator's Exchange database with your scheme actuary and advisers, if necessary. | |
| 8. | Understand how you will treat members' different entitlements with respect to the statutory winding-up order for your scheme and how this interacts with your scheme rules. | |
| 9. | Work with your employee benefit consultants to clarify scheme design structures. Verify with them that the scheme documentation and communications accurately and coherently explain the scheme design and benefits to members. | |
| 10. | Request your auditors to report on their testing of DB and DC entitlements and the separation of assets between DB and DC benefits. | |

| Checklist for action by scheme administrators | | Please tick ✓ |
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| 1. | Use separate bank accounts for DB and DC monies to avoid mixing of assets. | |
| 2. | Provide information to trustees that shows the DC assets are identifiable at all times. Report regularly on the robustness of systems and processes to ensure that DC assets are separately identifiable. | |
| 3. | Member communication should clearly state the different benefits held for members, including what happens in the event of a scheme wind-up. | |
| 4. | Provide reports on regular reconciliation of DC and DB assets carried out and cash flow statements, detailing movement of monies at a DC member level. | |
| 5. | Offer the open-market option and statutory money-purchase illustration to members with DC entitlements in line with legal requirements. | |
| 6. | Ensure individual member data accurately reflects/separates DB and DC entitlements. | |

| Checklist for action by employee benefit consultants and other advisers | | Please tick ✓ |
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| 1. | Advice to trustees on hybrid structures should state the advantages and disadvantages of such schemes and consider the employer's future growth strategies. | |
| 2. | Appropriate investment choices offered to DC members should consider the member population's risk appetite. Where same investment funds are used for DB and DC members, the approach should be justified and clear segregation of assets should be in place. | |
| 3. | Advice to trustees and employers should state the winding up strategies for hybrid schemes, their complexities and the different safeguards (including PPF) levels offered to the DB and DC members. | |

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