

THE DEPARTMENT FOR WORK AND PENSIONS

**RESPONSE TO THE REPORT
BY THE PARLIAMENTARY OMBUDSMAN**

“TRUSTING IN THE PENSIONS PROMISE”

June 2006

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Introduction

i. On Wednesday 15 March 2006 the Parliamentary Commissioner for Administration (the Ombudsman) published her report 'Trusting in the pensions promise'. The report was presented to Parliament under section 10 (3) of the Parliamentary Commissioner Act 1967. The report considered the circumstances in which final salary occupational pension schemes were wound up underfunded and the role of Government in this regard.

ii. In the first 146 pages of her report the Ombudsman sets out in detail a record of some of the key background to the winding up of certain final salary occupational pension schemes. This response adds to that, giving relevant context to some of the events.

iii. The Government wishes to place on public record that it has very great sympathy for those who have lost substantial sums of money due to their scheme being unable to meet its pension commitments. No one could deny the very real distress many people have experienced as a consequence.

iv. The Government was grateful to the Ombudsman for providing it with advance warning of her findings and recommendations. The Government first saw these, in draft, as early as December 2005. This meant that it was possible to consider the issues raised both seriously and carefully for some three months before they were finalised.

v. The Ombudsman asked the Government to respond to the findings and then to respond to her recommendations within two months

of publication of her report. The Government gave the Ombudsman's report very careful consideration, but could not agree with its findings and explained its reasons for this to the Ombudsman. In short, it does not believe that the report makes the case that the Government is responsible for the losses incurred. Given that the Government could not agree the findings of maladministration, it considered that any delay in responding to the recommendations could only have served to raise false hopes amongst the complainants concerned.

vi. On Wednesday 15 March the Government ensured that nothing fresh was contained in the published report that might require a review of its position. As nothing new was identified compared to earlier versions a letter was sent to the Ombudsman by the Permanent Secretary, giving the Department's formal response. In addition, a written statement was laid in both Houses of Parliament. The following day (Thursday, 16 March 2006) in an oral statement to the House of Commons (repeated in the House of Lords by Lord Hunt) the Secretary of State undertook to issue in the next few weeks, a "proper, full and formal response". The Secretary of State also undertook to "set out the details of our costings when we produce our fuller response".

vii. This paper fulfils these undertakings to explain more fully to Parliament the basis for the conclusions the Department came to in relation to the Ombudsman's report. These reasons were explained to the Ombudsman during the course of her investigation and in response to her draft reports.

The first section describes some of the background to the pensions system, examines some of the points made by the Ombudsman in her report and reiterates the Government's position on the Ombudsman's findings.

The second section and the accompanying Annex sets out the Government's response to the Ombudsman's recommendations and provides the Government's estimate of the cost of implementing the Ombudsman's proposals.

The third section summarises the Government's conclusion and actions already taken, and being taken, by the Government to protect pension scheme members.

Section 1: Background and Government's Response to the Ombudsman's Findings

The Report's Findings

1. The Ombudsman made three findings of maladministration. The first concerned information issued by the Department. She found:

“that official information - about the security that members of final salary occupational pension schemes could expect from the [Minimum Funding Requirement] MFR provided by the bodies under investigation - was sometimes inaccurate, often incomplete, largely inconsistent and therefore potentially misleading, and that this constituted maladministration.”

The Ombudsman also considered that the Department should have reviewed the official information which was publicly available in 2001. Finally, the report says that there is insufficient evidence to explain the rationale behind the Government's decision in 2002 to amend the MFR calculation.

2. Further the report finds that this maladministration was *“a significant factor in creating the environment in which....losses were crystallised.”*

Background

Salary-related Occupational Pension Schemes

3. Occupational pension schemes are voluntary arrangements set up by employers to offer pension benefits to their employees. Many are salary-related: that is the pension payable is related to the employee's salary (whether close to their retirement or averaged over their working life) and the length of time the person works for that employer and is a member of the scheme. Many offer ancillary benefits, such as death benefits for a surviving dependant.

4. Most such schemes are funded by contributions from employees (normally a fixed percentage of a person's salary) and the employer, who undertakes to meet the balance of the scheme costs. These funds, along with the returns from investing them, are used to pay the pensions as they become due.

Trusts and Trustees

5. Occupational pension schemes are generally set up as trusts. This allows them, and both the employer and the employees, to qualify for tax advantages and also ensures that the assets of the scheme are held separately from the company. A trust is an arrangement whereby a third party (the trustees) holds assets for the benefit of the beneficiaries of the trust (the members of the pension scheme). The trustees have a number of duties in relation to the scheme and its members, including ensuring that the assets of the pension scheme are invested prudently and that the scheme is administered properly.

6. As the Occupational Pensions Regulatory Authority (Opra)¹ said:

Guide for Pension Scheme Trustees (1997):

“Your role as a trustee is very important and responsible. The members of the scheme have placed their trust in you to ensure that their promised benefits will be paid. They will be looking to you to ensure that the scheme is administered efficiently and honestly. It is therefore very important that you understand and develop your knowledge.”

7. Complying with the relevant legislation is only the beginning of the trustees' duties. Further duties are set out in the trust deed. These normally include the ability to decide the investment strategy, amend the rules of the scheme and decide the level of contribution commonly in agreement with the employer. The trust deed may specify that some powers may only be used with the consent of the employer.

Government Involvement

8. The Government does not, in general, guarantee the security of private sector, occupational pension schemes. They are governed by a combination of trust law (both legislation and precedent), tax law and pensions and employment legislation.

9. The key legislation which is relevant to the issues raised by the Ombudsman is contained in the Pension Schemes Act 1993 and the

¹ The Occupational Pensions Regulatory Authority (Opra) was established from 6 April 1997 as a regulatory body with powers to monitor and enforce proper standards of administration in pension schemes in the UK. It was replaced by the Pensions Regulator in 2005.

Pensions Act 1995. Nothing in this legislation requires those responsible for pension schemes to ensure that their scheme is capable of paying all accrued rights in full at any time, regardless of what happens. Indeed it was made clear during the passage of the Pensions Act 1995 (see paragraph 31 below) that this was not possible either in practical or economic terms.

The Minimum Funding Requirement (MFR)

10. The Ombudsman's report focuses heavily on the Minimum Funding Requirement (MFR) which came into effect on 6 April 1997 as a result of the provisions of the Pensions Act 1995. Prior to 1997 there were no legislative requirements about the level of assets an on-going scheme needed to hold - this was decided in accordance with the rules of their scheme. The 1995 Act built on these arrangements and provided scheme members with greater (but not total) protection by introducing the MFR, which required private sector salary-related pension schemes to hold a minimum level of assets to meet their liabilities.

11. The MFR was never intended to require schemes to hold sufficient assets to ensure that all members' benefits could be fully secured should the scheme wind up (by purchasing annuities and deferred annuities from an insurance company). Instead it was intended to ensure that a scheme which was fully (ie 100%) funded on the basis of the MFR should have sufficient assets, in the event of it winding up, to protect fully pensions already in payment (by buying annuities), and to give younger members a cash amount which, if placed in a personal pension, would allow them a reasonable expectation - but not a guarantee - of achieving, at retirement, benefits equivalent to those lost.

12. The funding position was to be tested by the scheme actuary on at least a three-yearly cycle. Where the scheme did not satisfy the MFR, it had a given time to make up the shortfall. Nothing prevented the scheme holding more assets than the MFR required. It was envisaged that an appropriate level of scheme funding would continue to be determined in accordance with the rules of the scheme, with the MFR being precisely that: a minimum.

13. The MFR was introduced on a phased basis from April 1997. To allow schemes and employers the time to move smoothly from their old system to the new requirement, transitional rules allowed trustees to obtain their first MFR valuation in line with their scheme's existing (generally three-yearly) actuarial valuation cycle.

14. The MFR valuation involved the scheme actuary comparing the market value of the scheme's assets (stocks, shares, bonds etc) with a value placed on its liabilities (pensions in payment and, for those who had not retired, the value of the deferred benefits built up to the date of the valuation) on a specified date. The actuary followed guidance issued by the UK actuarial profession, and approved by Ministers, in carrying out these valuations. The actuary then provided a certificate to the scheme's trustees stating that either the scheme met the MFR or, if it did not, how much the shortfall was. This certificate, the format of which was laid down in legislation, emphasised to the trustees that meeting the MFR did not mean that the scheme could buy out fully all its liabilities. It said:

“Note:

The certification of the adequacy of rates of contribution for the purpose of securing the meeting of the minimum funding requirement is not a certification of their adequacy for the

purpose of securing the scheme's liabilities by the purchase of annuities, if the scheme wound up."

(Occupational Pension Schemes (Minimum Funding Requirement) and Actuarial Valuations) Regulations 1996)

15. If the scheme's first MFR valuation showed a shortfall, the trustees generally had until April 2003 to bring the funding up to 90 per cent of the MFR level and until April 2007 to reach 100 per cent.

Altering the MFR test

16. The operation of the MFR was affected by economic and demographic factors such as increases in longevity, changes in yields from equities and other investments, and changes in the costs of buying annuities. It was therefore inevitable that it would fluctuate against its original objective. It was for this reason that the UK actuarial profession monitored the operation of the MFR test from the outset, with a view to recommending changes when they considered adjustments were needed to ensure that the operation of the MFR remained consistent with the original policy objective.

17. To put it simply, if the MFR test was operating above the required level it would be offering a higher level of security than intended and would have required the employer to put in more money than needed to meet the policy objective; if operating below the required level, it would be offering a lower level of security than intended and would not have required the employer to put in as much money as needed to meet the policy objective.

Official Information

18. Chapter 4 of the Ombudsman's report - "The documentary evidence" – refers to various statements made about occupational pension schemes during Parliamentary debates, and by Government bodies in leaflets and press releases etc. These are used as evidence to support the assertion that the Government did not provide full and accurate information. The Government does not accept this. The Government believes that the purpose of those statements needs to be set in a wider context, including the other information that would have been available to individuals.

Leaflets

19. Departmental leaflets are designed to offer the reader basic information about a particular subject (be it occupational pensions or a social security benefit). As was said in the consultation document "Regulation, advice and information: the Government's proposals"

"The Government already produces a number of basic information leaflets on pensions. The aim of these is to provide straightforward explanations to enable people to understand the main pensions options and the differences between them. The FSA also produces a number of consumer guides....Such information is not, however, intended to be sufficient in itself to enable someone to decide about their pension needs, nor to choose between different schemes."

2 August 1999

Given that the information is aimed at the general public, leaflets normally concentrate on what might be called “mainstream” circumstances. In relation to occupational pensions, this means that they offer broad explanations that apply to the majority of members of pension schemes.

20. They are explicitly not designed, however, to provide information tailored to the circumstances of particular individuals and people are expressly warned not to assume that the broad information given can be applied without question to their own situation. Their limited scope and nature is made clear by a general warning and the reader is told where more specific information can be obtained.

21. The principal Departmental leaflets considered by the Ombudsman are:

- (a) the **PEC3 “The 1995 Pensions Act”** issued as a one-off print in January 1996;
- (b) two editions of the **PM1 “A Guide to Your Pension Options”** (July 2001 and April 2003);
- (c) three editions of the **PM3 “Occupational Pensions: Your Guide”** (May 2002; April 2003; April 2004);
- (d) two editions of the **PM7 “Contracted-out Pensions: Your Guide”** (April 2003 and April 2004).

In addition, the Ombudsman considered three guides for pension scheme trustees issued by Opra: a general guide in 1997; and two specific guides to the MFR in 1999 and 2003.

22. As each leaflet served a different purpose they did not all contain the same information but such differences were appropriate in the

circumstances. The Government does not believe that the reader of any or all of these leaflets should have been left in any doubt that they would have needed more information to get a full picture of their own individual circumstances. Each of the leaflets made clear that they were designed to offer only generic, high level information. For example:

22.1 The PEC3 said that it was intended to be “**a brief summary of the changes**” in the 1995 Pensions Act. In a wide-ranging leaflet of 21 pages it covered the MFR in just four sentences;

22.2 The PM1 leaflet said that it was (and is) an “**introductory guide**” to pensions. Inevitably with such a large and complex subject as pensions, it devoted only a page and a half to occupational pensions;

22.3 The PM3 leaflet which was (and is) a guide to occupational pensions said explicitly that the guide “**looks at some questions you may need to think about and it tells you where you can find more information.**”

23. All of the leaflets contained explicit warnings that they were not complete explanations. Typically they said “**This leaflet is for guidance only. It is not a complete statement of the law**”. The Government considers that, taken together, such warnings should have been sufficient to alert the reader that they were not being given the full detail of the issues covered by the leaflet and that the leaflet was not comprehensive.

24. The Government does not consider it would have been appropriate to cover the MFR in the PM leaflet series as the Ombudsman suggests. As stated above, the PM1 leaflet was an

introductory guide in which occupational pensions were covered in a page and a half. The series was designed as part of a wider set of communications to encourage those who had not made provision for their retirement to consider doing so and gave people a starting point for this, as is made clear. The PM1 said on the first page ***“If you want to enjoy your retirement, you need to plan how you are going to save for it.”*** and also ***“These guides can give you helpful information, but only you can make decisions about your pension.”*** It said further on ***“If you are not sure what to do for the best, you can get advice from a financial advisor.”*** and the heading after this was ***“Where do I start?”***

25. Scheme members did indeed have access to other, more specific, information. As the actuarial profession’s report in “Communication of MFR and Solvency” said ***“Members will also have access to the actuarial valuation, actuarial certificates and Annual Report as well as their Scheme Booklet.”***

26. Even the 1997 Opra Guide, which was designed for a much more specialised audience of scheme trustees, did not attempt to cover the MFR comprehensively, and gave the reader the same warning: ***“..this guide should not be taken as a definitive statement of the law. There is no substitute for obtaining professional advice....”***

Other official information

27. The Government has closely examined the other information to which the Ombudsman refers such as press releases and Ministerial statements in Parliament and believe these to be accurate, in their context.

28. The Ombudsman's report quotes extensively from a statement made by the then Secretary of State for Social Security in March 2000, for instance ***"The giving of wrong information by a government department is inexcusable. There is a clear responsibility to ensure that the information provided is accurate and complete."*** (paragraph 7.106) and ***"...we will also provide redress for those people who were wrongly informed and who, had they known the true position, might have made different arrangements...As a matter of principle, we believe that when someone loses out because they were given the wrong information by a government department, they are entitled to redress."*** (paragraph 7.107).

29. The report appears to be putting forward the proposition that these statements support the Ombudsman's approach in this case. However, the then Secretary of State for Social Security was speaking in relation to incorrect information given by the then Department of Social Security in relation to the amount of SERPS a surviving spouse could inherit. This was a system where the Government was completely responsible for the structure, including the administration. Additionally, in this case the information given was, at least in some cases, positively wrong. Occupational pensions, by contrast, are administered, by the individual schemes' trustees. Nothing the Government did created the losses incurred. The Government stands by the statement made by the then Secretary of State in March 2000 in relation to schemes and services which it operates, but that situation simply does not apply here.

30. General press releases and Ministerial speeches in Parliament would not normally be suitable vehicles for explaining a complex issue such as the MFR. For instance, the findings in the report refers to a Commons debate on employment pension schemes in July 2001 as an example of *"conflicting messages"* which *"were being given about the*

security afforded by the MFR...". But the main focus of that debate was the position of trustees and trust law. It would have been inappropriate for the Minister to have spent the limited time available explaining the MFR in detail, rather than dealing with the main concerns of MPs attending the debate.

31. However, when appropriate the level of security offered by the MFR was explicitly referred to. For example:

Lord MacKay: 7 February 1995: ***"It is simply not possible either practically or economically to require ongoing pension schemes to fund at a level that will enable them to buy out all their liabilities with non-profit annuities. For many schemes the cost would be prohibitive..."***

Jeff Rooker: 3 April 2000: ***"The minimum funding requirement is not a guarantee of solvency"***

Scheme specific information and the role of trustees

32. It is clear that the only people who could give information about the specific circumstances of their scheme were the trustees and sponsoring employer of the scheme in question. As the leaflet PM1 said ***"If you are in any doubt, get as much information as you can (for example, by reading information from the scheme provider or by talking to a union representative or financial advisor) before you decide."***

33. As set out in paragraphs 5 to 7 above, the role of the trustee was, and is, crucial in this respect. The 1997 Opra guide said:

***'...members of the scheme have placed their trust in you to look after financial assets that will provide their benefits' and
'The duty to act prudently is particularly important when dealing with the scheme's investments. It means...considering the risks involved, obtaining and acting on appropriate professional advice'.***

The 1999 Opra guide to the MFR said:

'You [the trustee] should always get appropriate legal advice about how the Pensions Act will affect your scheme. You will also need the advice of the scheme actuary. You should make sure you understand what your advisor's role is and that you understand the advice you are given'

34. These were, and are, substantial responsibilities for trustees, many of whom act in a voluntary or unpaid capacity. It is nevertheless the case that all would have had professional advice available to them - indeed the law required and requires that to be the case. There is no question that those advisers – particularly the schemes' actuaries – would have been in any doubt about the actual level of security offered by the MFR from time to time. Additionally their advice would inevitably have made clear that the trustees could not have relied upon the scheme meeting the MFR to satisfy themselves as to whether the assets were sufficient in the case of their own particular scheme. They would have had to rely on other mechanisms and professional advice in making their judgments.

35. If and when the adequacy of the scheme's assets had been tested against the MFR, the actuarial certificate would have clearly stated that meeting the MFR did not equate to the scheme being able fully to buy out all members' benefits - as was the case for all MFR valuations (see paragraph 14 above). That crucial point was reinforced in the Opra publication "A Guide to the Minimum Funding Requirement: a summary for pension scheme trustees" issued in May 1999 which said ***"This [meeting the MFR] will not necessarily ensure that all of a scheme's liabilities can be met fully if the scheme were to be wound up."***

Conclusion

36. It was the fundamental responsibility of trustees and employers to provide detailed information on their schemes to their scheme members. These were not the Government's pension schemes. Their trustees were not the Government's trustees. The Government did ensure - through Opra guides and actuarial certificates - that trustees were guided towards the information they needed. The other more general information which the Government provided in its leaflets was intended only to provide basic information and its limitations were made clear. The Government does not accept the finding that this information was potentially misleading and, thus, maladministrative.

Reviewing information in 2001

37. In September 2000 the Department published a report by the actuarial profession ("Review of the Minimum Funding Requirement"), part of which covered the issue of disclosure. After describing the protection offered by the MFR, the report said that the profession was concerned that this ***"..is not understood by members, trustees and***

employers, who believe that the benefits from a scheme which meets the MFR are fully secure". It went on "It is therefore a key conclusion of the review that there should be a full and clear disclosure to members of the objectives and limitations of the MFR test and the consequences if their scheme should be wound up. We recognise that thiscould have major consequences as almost all employers and trustees have, until now, tended to stress the security aspects of occupational pension schemes in their communications with members."

38. The Ombudsman believes that, on the basis of this report, the Government should have reviewed the official information which was then available. The Government does not believe that the report should have triggered such a review given that:

- none of the Departmental leaflets in circulation at that time was targeted at existing members of pension schemes. As is made clear above, the PM leaflet series was designed to help people who had yet to begin saving for their retirement and the Opra Guide was designed to inform scheme trustees;
- no one suggested that the Department was the appropriate body to inform scheme members about the position of the MFR in relation to individuals. The actuarial profession's report itself said **"...Scheme Actuaries should encourage trustees to provide members with the information necessary to address any incorrect perceptions of the MFR."** The discussions around this subject were concerned with how trustees (not the Government) could give their members proper information about the funding position of the scheme, without unduly alarming them; and

- the report did not suggest that Departmental leaflets had created or were adding to the confusion.

Conclusion

39. For these reasons the Government does not accept that the decision not to review published information in 2001 was maladministrative.

The decision taken in 2002 to adjust the MFR

40. The Ombudsman's report refers to four Government decisions regarding the operation of the MFR, only two of which (the June 1998 decision and the March 2001 decision) were part of the complaint investigated:

40.1 In **May 1998** the actuarial profession recommended changes which brought the MFR down to its original level. These changes were agreed by the Government in **June 1998**. This decision was part of the complaint and the Ombudsman found it was not made with maladministration;

40.2 In **May 2000** the actuarial profession recommended changes which would have increased the level of the MFR. These were not accepted by the Government in **March 2001**. This decision was not part of the complaint and the Ombudsman made no finding in relation to this decision;

40.3 In **September 2001** the actuarial profession recommended changes which would have lowered the MFR. These changes were accepted by the Government in **March 2002**. This decision was part

of the complaint and the Ombudsman found that the Department was maladministrative;

40.4 In **February 2003** the actuarial profession made a final recommendation to increase the level of the MFR. The Government did not accept these proposed changes. Again, this decision was not part of the complaint and the Ombudsman made no finding in relation to it.

41. The Department has explained the rationale behind each of these four decisions to the Ombudsman. Each decision was taken based on a consistent judgement of two issues:

- whether the change would restore the MFR to its original level; and
- whether the change was sufficiently straightforward to allow it to be implemented before planned changes to the MFR were expected to be introduced.

42. In her report the Ombudsman finds that the **1998 decision** was not taken with maladministration, but finds that there was a lack of evidence to support the Government's decision to amend the Market Valuation Adjustment in **March 2002**. The Government notes, however, the Ombudsman's view that this change did not have any effect on the losses incurred by scheme members (paragraph 5.226 of the Ombudsman's report).

The March 2002 Decision

43. The Government believes that there is ample evidence to demonstrate why the decision was made to accept the actuarial

profession's September 2001 recommendation. (The Government regrets in this context that the Ombudsman has declined to show the Government the actuarial advice that she obtained, and which is referred to in her report, which might have enabled any remaining doubts or misunderstandings to be resolved.)

44. The decision making process was consistent with how previous decisions had been made:

44.1 There was a clear recommendation from the actuarial profession, which had been developed by a committee containing leading technical experts from most of the major firms of actuaries.

44.2 Following receipt of this recommendation the Government Actuary's Department (GAD) was asked to consider it and to give an opinion on the recommendation. They responded by endorsing the profession's view without qualification.

44.3 The Department then considered whether there were any overriding policy reasons why it should not accept the actuarial profession's recommendation. In particular the Department had to consider whether the recommended change was sufficiently straightforward to allow for it to be implemented before the MFR was expected to be replaced.

44.4 The change to the MFR recommended by the profession in September 2001 could be implemented quickly and without undue costs to schemes. This was in contrast with the change recommended in May 2000 which the Department rejected (in March 2001). Following consultation with the industry it was found

that the changes recommended in May 2000 would have been unjustifiably costly and time consuming for schemes to implement, given that the MFR was expected to be shortly replaced.

.45. A reference has been made in the report (paragraph 5.105) to the fact that the Department rejected the recommendations that would “*increase the degree of protection afforded to scheme members*”. This is to misunderstand the impact of changes to the MFR calculation.

46. Even if a change to the MFR did require employers to fund the scheme at a higher level, the effect of that change would not have produced any immediate improvement in the level of security. The point made by the Government Actuary to the Ombudsman, in relation to the May 2000 change, has a wider application. He said: “***Changes to the MFR were intended to provide incentives to schemes to improve their funding levels, although these changes could not achieve this immediately. Thus if the profession’s May 2000 recommendations had been implemented, this would simply have led to schemes, in the short run, showing a lower percentage of coverage against the MFR.***”

Conclusion

47. The Government received a recommendation from the UK actuarial profession (as part of its role in continually monitoring the actuarial basis for the MFR) which was backed by the GAD and acted upon it. The Government does not believe that this decision was made with maladministration. The Government Actuary, in commenting to the Ombudsman on this issue (as is recorded in her report), has said that he considers that the evidence base for this decision was “***extremely***

strong and much stronger than for many (probably most) of the decisions that have to be taken by Government". The Government does not believe that this decision was made with maladministration. Indeed, the Government would have needed strong grounds to justify not acting on the recommendation. No such grounds were apparent at the time.

Link between official information and losses incurred

48. The Ombudsman's report acknowledges that the losses suffered by those who complained to her were caused by a number of factors.

49. As her report notes, the immediate problem was that schemes wound up at a time when the assets held were not sufficiently valuable to secure all the scheme's liabilities. One key contributory factor here was the sustained downturn in world stock markets in 2000/01 - potentially affecting the value of the scheme's assets - and the associated economic situation, which may have been a factor in some insolvencies, which would have triggered the winding up of the pension scheme.

50. There were also other, less immediate, factors. The investment strategy of an individual scheme would have determined how far the scheme was exposed to the risk of a stock market downturn. In addition, at wind-up, pensioner members generally have their pensions secured by buying an annuity from an insurance company. Because of unanticipated increases in longevity and falls in interest rates, these annuities turned out to cost substantially more than previously, leaving less to be shared between the non-pensioner members.

51. The report also points to the pivotal role of the employer - where the company was solvent – given that triggering the wind-up in this situation is normally a voluntary action by such an employer.

Actions influenced by the official information

52. The Ombudsman’s report nevertheless maintains that if members had had sufficient information they might have taken different actions to safeguard their pension income. The Government does not agree with the Ombudsman on the sufficiency of the official information on the MFR. Furthermore it does not believe that there is a link between that information and the actions taken nor that scheme members would have necessarily acted differently, had the official information been worded in another manner.

53. Crucially, a number of the schemes covered by the report would not have had an MFR valuation before they went into wind-up. In these cases, self-evidently, members, even if properly advised about the limitations of the MFR, could not have taken account of such a valuation. Other schemes, which had had a valuation, would have been found to have been underfunded against this test. Even if the members of these schemes had believed that, if their scheme was funded up to the MFR, they were fully protected, they could not have believed this protection applied to their scheme if underfunded. Therefore, any decision they made to join or stay in that scheme in these circumstances could not have been influenced by a belief that their scheme, was in some way, ‘safe’.

54. Where their scheme had been the subject of a MFR valuation and had been found to have complied with it, it is clearly more plausible that the scheme’s members might have sought to act differently if they had

had a fuller explanation of what safeguards this did, and did not, provide. Even in those circumstances, however, and leaving aside the issue of the responsibility for any such lack of a fuller explanation, it is the Government's view that any action that could have been taken by members, either individually or collectively, would have been unlikely to have protected a greater part of their accrued rights, much less protected all of them. Indeed many possible actions would have exposed them to potentially greater risks.

55. For example, taking some of the possibilities raised in the Ombudsman's report, it would have been very difficult to persuade an employer to inject more money into a scheme when that company was itself in serious financial difficulties. In addition it would have been surprising if the employer in such circumstances would have been able to find another company willing to take it over and fund the pension deficit.

56. Where individuals wanted to transfer their money out of their occupational pension scheme and to remain working for the sponsoring employer, their only realistic option would have been to have transferred their share of the fund (which might have been reduced by the scheme) into a personal pension. This would, however, have left them still exposed to the risk of stock market movements and the general economic situation, as well as having to pay management costs and is likely to have deprived them of the employers' contribution. How much they would have lost or gained from such a transfer would be dependent on the company from which they chose to buy their personal pension and would not have been known until they reached retirement age.

Conclusion

57. For the reasons set out earlier in this response, the Government does not believe that the information issued by the Government can be regarded as having caused the losses described in the report.

- It was the fundamental responsibility of trustees and employers to provide detailed information on their schemes to their scheme members.
- The Government does not believe that the information it issued was inaccurate or misleading in its context on the level of security scheme members could expect, if their scheme was funded to the MFR.
- Given the context and the intended audience, the information was complete.
- The leaflets were clearly limited in nature and contained clear warnings. Any reader would have been left in no doubt that they needed more information to get a full picture.
- As each leaflet served a different purpose they did not all contain the same information but such differences were appropriate in the circumstances and context of each leaflet.
- The Government does not believe that the report of the actuarial profession “Review of the Minimum Funding Requirement” should

have triggered a review of Departmental literature - the report was looking at how scheme trustees can communicate with their members.

- The Department had more than sufficient information on which to make its decision on the MFR in March 2002.

- The causal link between the alleged maladministration and individual losses has not been made:
 - many schemes were not funded to the MFR, therefore the protection it may or may not have offered scheme members could not have been taken into account by them when reaching their decisions;
 - any action members could have taken would not have protected a greater part of their pensions.

Section 2: The Government Response to the Ombudsman's Recommendations

58. The Ombudsman's report does not say that the Government alone caused the pension losses and does not, therefore, make recommendations based on the normal principle of putting people back into the position they would have been in had the alleged maladministration not taken place. Instead it recommends that the Government considers whether it should replace all the benefits lost by members of underfunded schemes which went into wind up between (a) 6 April 1997 and 31 March 2004; and (b) 1 April 2004 and 6 April 2005, acknowledging as it does that this raises significant public policy questions.

59. As the Ombudsman recommended, the Government did consider the report's proposals but rejected them because:

59.1 as explained in Section 1 it does not accept the findings of the report that the Department's official information was misleading, or that this information led to the losses suffered by those covered by the report;

59.2 it noted that the recommendations went well beyond the accepted principle of putting people back into the position they would have been in, had the alleged maladministration not taken place, and considered acceptance would create a significant precedent across Government;

59.3 the Government believes it is not right to use taxpayers' money to compensate people for losses which reflect the risks inherent in most, if not all, financial and investment decisions, unless that loss is caused by its wrongful actions. It did not appear to be in the wider public interest to make an exception in this case;

59.4 the cost would be significant: at some £15 billion in cash terms over 60 years. While at the beginning of the period, the amounts would be lower, they would rise over time, reaching some £400 million a year by around 2030.

60. The Government was also asked to consider making consolatory payments to members of schemes that wound up underfunded between 6 April 1997 and 31 March 2004. This was considered and also rejected for the reasons given in the previous Section.

61. The Government was additionally asked to consider apologising to all scheme trustees. The Government considered this and rejected it, as it does not believe that trustees were in any way misled by official information. The Opra Guides made trustees' responsibilities clear and they always had access to professional advice.

62. Finally, the Government has accepted the recommendation of the Ombudsman to review the time it takes to wind up a salary-related pension scheme. It is also concerned about the time this takes and has begun work on this issue, although it notes that many of the reasons for delays are not within the influence of the Government. The Government will report further on the progress of this work in due course.

Section 3: Conclusion

63. The Ombudsman has investigated the complaints put to her in line with the Parliamentary Commissioner Act and has reached a view that an injustice arose from what she considered to be maladministration. She has quite properly reported her findings to Parliament. In the same way, the Government has reported to Parliament why it cannot accept them. It has been suggested that the Government's course of action might be to have the Ombudsman's opinion judicially reviewed, but the Government considers that the proper approach in such a situation is to provide its response to Parliament.

64. While the Government has rejected reports in the past (for instance, in relation to the Barlow Clowes investigation in 1989) no Government does so lightly. Nor do Governments reject recommendations made by the Ombudsman without serious and very careful consideration. Despite hundreds of complaints being investigated by the Ombudsman each year, this is the first time that the Department for Work and Pensions (and its predecessors) has been unable to agree such findings and recommendations since the role of the Ombudsman was created in 1967. It is right for the Government to report this to Parliament in the way it is doing.

65. Where employers become insolvent the Government has introduced two major measures: the Pension Protection Fund and the Financial Assistance Scheme.

The Pension Protection Fund

66. The Pension Protection Fund will provide compensation for the members of most salary-related occupational pension schemes in the event of the insolvency of their sponsoring employer on or after 6 April 2005. Details of the operation of the Fund, including the levels of compensation and eligibility conditions can be found at <http://www.pensionprotectionfund.org.uk/>

The Financial Assistance Scheme

67. For those affected by the winding-up of their scheme following employer insolvency prior to 6 April 2005 the Government had already set up – before the Ombudsman’s enquiry began - the Financial Assistance Scheme to provide a limited level of assistance to those within three years of their scheme pension age at 14th May 2004. The Government initially made available £400 million to support payments under the scheme over 20 years.

68. The Government had intended to review the scheme as part of its 2007 Spending Review. In the light of the Ombudsman’s report the review was expedited. In the White Paper, “*Security in retirement towards a new pension system*” (Cm 6841), published on 25th May, the Government announced that the scheme would be extended.

69. Eligibility has now been extended to people within fifteen years of their scheme pension age. This involves tapers from 80 per cent of expected pension for those within 7 years of their scheme pension age, 65 per cent if between 7 and 11 years, and 50 per cent for those between 12 and 15 years. This should ensure that around 40,000 people are helped. The total cash cost of assistance is expected to be around £2.3 billion over the lifetime of the scheme.

70. Details of the operation of the scheme, including the levels of assistance and eligibility conditions, can be found at:

<http://www.dwp.gov.uk/lifeevent/penret/penreform/fas>.

Regulations with further details of the proposed extension will be published shortly.

Annex

Introduction

1. This Annex provides an explanation of the methodology and assumptions underlying the Government's estimate of the cost to Government of implementing the Ombudsman's proposals.
2. The Ombudsman asks the Government to consider the replacement of the entirety of the pension which affected individuals would have received had their pension scheme not wound up or started to wind up with insufficient funds to meet all of its liabilities (core benefits) and associated benefits, such as life cover, survivor benefits and ill-health benefits (non-core benefits). The recommendations cover schemes which started to wind up between 1 April 1997 and 5 April 2005. This includes pension schemes with solvent sponsoring employers which are not covered by either the Financial Assistance Scheme or the Pension Protection Fund.
3. The Government estimates that implementing the Ombudsman's proposals would cost between £13 billion and £17 billion over 60 years in cash terms. Annual costs would vary over time, peaking at some £400 million around the year 2030.
4. The following assumptions were used to estimate the cost of the Ombudsman's proposals:
 - 125,000 eligible pensioner and non-pensioner members;
 - an average funding level of schemes in respect of non-pensioner members of 30-35%;

- an average accrued pension for non-pensioner members of £3,300 per year;
- longevity estimates from standard tables from the UK actuarial profession's Continuous Mortality Investigation, based on the longevity experienced by pensioners whose pensions are secured with insurance companies.

The estimates are based on the expected cost over 60 years as the proposals cover all members who have suffered losses to their pension (some of whom may have been young when their scheme started to wind up) as well as their survivors. Costs would run further into the future but would be low after 60 years. Further detail on these assumptions is set out below.

Costing Methodology

5. Estimates of the cost to Government of implementing the recommendations in the Ombudsman's report are based on the model and data previously used to estimate the costs of the Financial Assistance Scheme (FAS).
6. In order to determine the likely cost of the FAS, data were collected on the numbers and characteristics of 380 pension schemes and specific data were collected on some 1,300 members of a smaller number of schemes thought to be reasonably representative of the total number. To estimate the cost of implementing the Ombudsman's proposals, these data, together with scaling parameters, have then been fed into an actuarial model to generate detailed time profiles of costs. To profile expected payments, the model makes a prudent assumption about scheme members' life

expectancy, and also allows for specific features of the design of their pension scheme (for example, indexation after retirement, revaluation before retirement and normal retirement age).

7. The actuarial model uses data on members to calculate the amount of pension that would be paid in each year to each individual in the sample. The key pieces of information used to calculate these costs are: age, retirement age, accrued pension, percentage of pension lost and the likely longevity of eligible members and any survivors. The results, in terms of likely cash flow in each year, are scaled up to the level of the total assumed numbers of affected scheme members.
8. For example, if an individual is 55 years old and is a member of a scheme with a normal retirement age of 65, the model will revalue the individual's pension for 10 years, and start payments in year 11 when the individual has retired. The model will then apply the longevity assumptions and any assumed survivors' benefit to calculate the number of years in which payments need to be made. This process is repeated for each of the members in the sample and is subsequently scaled up to the population level.
9. This process leads to a complex but robust model, based on actual data, rather than a number of generalisations and broad assumptions. It does, however, mean that any simplifications of the model may be misleading, if the sophistication of the model is not taken into account.
10. A number of complex assumptions form the basis of the calculations. All of the key assumptions used in the calculation are data-based, as follows:

- **Number of eligible members:** 125,000 pensioner and non-pensioner members.
 - The great bulk of the members eligible for the proposed arrangement would be non-pensioners. The 380 schemes on which data were collected have around 70,000 non-pensioner members in total. In addition, DWP estimate that a few hundred more schemes, including a further 50,000 or so non-pensioner members, could have suffered losses. This estimate is based on DWP's data collection exercise and data from the Pension Schemes Registry, maintained by The Pensions Regulator (formerly Opra). DWP estimate that only around 5,000 pensioners would be eligible for payment as, because they are higher up the priority order, their pensions are already more highly protected than non-pensioner members and thus they are less likely to experience significant losses in their benefits.

- **The assumed funding level of eligible schemes.** The average funding level from the schemes' assets for a non-pensioner member is assumed to be around 30-35% of the cost of securing pension benefits.
 - This estimate is based on the average funding level of the schemes in the data collection exercise outlined in paragraph 6. For each scenario modelled, 30% is used to provide a lower estimate and 35% is used to provide an upper estimate.

- **The average accrued pension** of all non-pensioner members in eligible schemes is assumed to be around £3,300 per year.
 - This estimate is based on the average accrued pension of the 1,300 members in the data collection exercise. The accrued

pensions are varied by 15% to provide upper and lower estimates for each scenario modelled.

- ***The longevity expectation*** of eligible members and their survivors which determine the length of time payments need to be made. The longevity estimates are taken from standard tables from the UK actuarial profession's Continuous Mortality Investigation. These are based on the longevity experienced by pensioners whose pensions are secured with insurance companies, and include allowance for future improvements in longevity. They are commonly used for estimating the longevity of members of pension schemes.
- ***Ages of eligible members***. The age of eligible members would affect the number of years in which they would be entitled to revaluation and indexation respectively, the year in which they retire and the number of years that they would receive pension payments. The values are based on the actual ages of the 1,300 members from our data collection exercise.

Ombudsman's Proposals

11. The Ombudsman suggested that the Government should consider the replacement of both core and non-core benefits. For the purposes of these estimates core benefits are assumed to mean the monthly payments individuals would have received from their pension scheme on retirement if they had become deferred members of an on-going scheme at the point of wind up.

12. The assumptions made in relation to the most common non-core benefits which have been taken into account in the costings are as follows:

- a. Lump sums – The costing methodology is based on schemes' total accrued liabilities and therefore includes a proportion of the pension that individuals could take as a lump sum. The expenditure profile has been adjusted to take into account that providing lump sums would increase expenditure in the early years of the arrangement.
- b. Survivors – It is common for pension schemes to provide survivors rights at 50% of the rate of the original member's pension. However, some schemes provide more generous survivors' rights. The costings therefore looked at a range of values of survivors' rights in order to check the sensitivity of the costs to different levels of this benefit.
- c. Early retirement on ill health grounds – This would allow members to take their pension before normal pension age, normally not at a reduced rate (as would be the case for voluntary early retirement), and sometimes at an enhanced rate, to reflect the loss of service due to ill-health. Due to the complexity of this benefit it has not been included in estimates. Therefore, if the arrangement were to pay pensions to people in ill health at below normal pension age, there would be an increase in cost above the current estimates.
- d. Revaluation in deferment – The modelling assumes broadly scheme-specific rules up to the date of the start of winding up for each scheme and a standard rate after the start of winding

up, in line with the Financial Assistance Scheme calculation. Applying scheme specific revaluation after the start of the winding up in the calculation of the benefits that members have lost would generally increase costs, but the overall effect would be small and, for simplicity, this adjustment has not been made in the central estimates of the cost of implementing the Ombudsman's proposals. However, costs have been modelled under a range of rates of revaluation, in order to establish how this might affect the overall costs.

- e. Indexation after retirement – The modelling assumed indexation at a rate of 2.5 per cent, to reflect the fact that statutory Limited Price Indexation (LPI) requires pensions in payment to be increased in line with inflation capped at 2.5 per cent for rights accrued from 2005 onwards. No account has been taken of the way rates of indexation vary among schemes or of the more generous requirements that existed in the past.

Solvent Employers

13. There is very limited data on the numbers and circumstances of schemes with solvent employers which have wound up underfunded. Therefore it is not possible to estimate the costs of including these schemes with any certainty. The issue of schemes with solvent employers is complex, as many members of such schemes will have suffered small losses, if any loss at all (for example, where wind up is due to a merger of schemes and members are transferred to a different scheme providing the same benefits). Indicative estimates are that allowing for schemes with solvent employers could increase the costs by up to 25 per cent.
14. However, given the high level of uncertainties already inherent in the assumptions underlying the base costings, and the different circumstances of schemes winding up with solvent employers (e.g. possibly higher funding levels), simply enhancing the base costing by 25 per cent would lead to an estimate with a very high degree of variability. The costs of covering schemes with solvent employers have therefore not been included in these estimates. These costings are thus likely to be an underestimate of the true cost.

Analytical Concerns

15. Given the limited information available on pension scheme members, their accrued pension entitlement and the level of losses they have incurred, the estimates are based on the assumptions outlined in paragraph 10 above. It would not be possible to provide a more reliable estimate until a significant number of schemes have

completed winding up and have calculated their final assets and liabilities.

16. The range of estimates for the costs of restoring the full pensions of all members affected can be very large. Restoring each member's rights to 100 per cent would mean that the rules of each scheme which has begun winding up between 1997 and 2004 would have to be replicated in order that all members received exactly what they would have received from their scheme, had the scheme remained in place and the non-pensioner members become deferred members of the scheme. This would lead to an extremely complex arrangement where, for example, indexation and revaluation requirements would differ for members depending on the rules of their original scheme, and possibly differ over time for the same member, if their scheme had changed its rules during the period the individual was a member.
17. These complexities have been approximated by using a range of modelling assumptions and testing the sensitivity of the costs to these assumptions. There is, however, a risk that the costs would change significantly, depending on any final definition of the details of the arrangement.

Scenario Analysis

18. In order to be more confident of the range of possible estimates of the costs of the arrangement, some scenario analysis has been carried out. This approach is based on varying the non-core benefit assumptions in order to check the sensitivity of the outputs to the inputs. Thirteen scenarios were modelled as outlined below:

- **Pension Age (4 scenarios)** – the pension age used in the model was varied in order to determine the sensitivity to scheme-specific retirement ages. If implementation of the Ombudsman’s recommendations required scheme-specific pension ages to be used, the average pension age is likely to be less than 65. The values modelled were scheme pension age, fixed at 65, fixed at 62, and fixed at 60.
- **Revaluation in deferment (3 scenarios)** – currently the assumed rate of revaluation of pensions in deferment is 2.5%. However this may be higher in some schemes and so the effective rate of revaluation may therefore be higher. The values modelled were 2.5 per cent, 3 per cent, 4 per cent.
- **Survivors’ benefits (3 scenarios)** – some members will have more than 50% survivors’ rights. The values modelled were 50 per cent, 55 per cent, and 60 per cent.

Costs and Numbers Helped

19. The table below shows the range of cash and net present value² costs of providing full compensation to all affected members. Paragraph 12(e) outlines why 2.5 per cent indexation is the most appropriate assumption. The range of costs is a result of the scenario analysis on pension age, revaluation in deferment and survivor’s benefit.

² Net Present Value is used to compare costs that occur in different time periods. It is a separate concept to inflation and is based on the principle of ‘time preference’, i.e. that people prefer to receive goods and services now rather than later. NPV Costs discount cash costs by 2.5% per year to convert cash costs into real costs (to take account of inflation) and, in addition, by 3.5% a year in years 0-29, and by 3% a year in years 30 onwards to convert real costs into NPV costs (to take into account time preference).

20. DWP estimate that the arrangement would provide compensation to 125,000 pensioner and non-pensioner members.

£billion

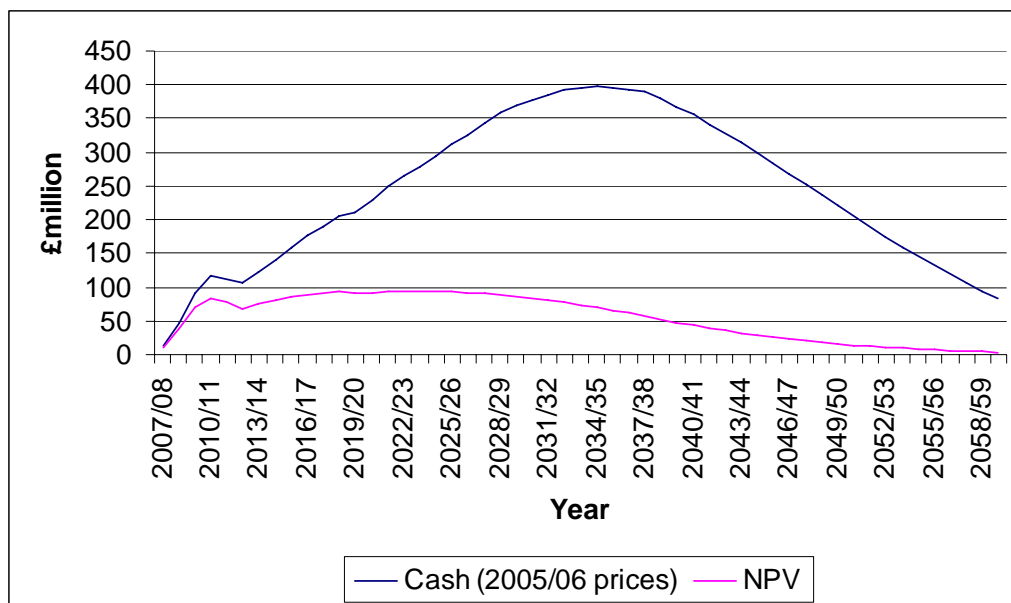
	Cash Cost	Net Present Value
2.5% indexation	13-17	2.9-3.7

Notes:

- 2005/06 prices
- NPV Costs discount cash costs by 2.5% per year to convert cash costs into real costs and, in addition, by 3.5% a year in years 0-29, and by 3% a year in years 30 onwards to convert real costs into NPV costs.

21. The estimates are based on the expected cost over 60 years, the likely duration of benefits under the current FAS. However, given that an arrangement to meet the Ombudsman's requirements would cover all members of the affected schemes, the costs of the arrangements would run further into the future. The arrangement would need to continue paying out until the last survivor of a member of any scheme currently winding up had died (for example, if the member is 25 today, and lives until age 95, payment would be continuing in 70 years time, or later if the member left a survivor). Costs after 60 years would be low especially in NPV terms, but would add to the total cost.

22. The graph below shows the typical long-term cost profile (the cost profiles for different scenarios may vary somewhat but this represents the typical shape):



23. The costs presented here are gross figures which do not take into account the increased tax revenue and reduced income-related benefit expenditure which would arise. It is difficult to estimate precisely, over such a long period, what the cost would be after taking these adjustments into account, as this will depend on the income distribution of people affected, the tax brackets they are in and their benefit entitlements.

Administration Costs

24. It is difficult to estimate the administration costs of an arrangement providing a full restoration of pensions to all those covered by the Ombudsman’s report. As the arrangement would have to mirror the benefit structures for each qualifying pension scheme, it would be significantly more complex than either the Financial Assistance Scheme or the Pension Protection Fund.

25. Based on experience to date with known schemes, we estimate that one off set up costs might be around £10 million and during the first five years that it might take to assess scheme eligibility and calculate

member benefits, the administration costs could be at least £14 million a year. The total costs over the first year or so reflecting the one off costs could therefore be around £20 million. Once the take on was complete and the main task became the payment of pensions, the costs would be expected to reduce.