



## Helping you weigh the options

Is winding up a DC pension scheme in members' best interests?

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Many employers today will have one or more legacy defined contribution ("DC") occupational pension schemes. Frequently such schemes have only a small number of deferred pensioners and an even smaller number of active members.

For employers, the costs of administration and governance are likely to be disproportionate to the number of members. For trustees, it may be difficult to meet current governance standards and "value for money" requirements. For older, insured DC schemes (where all contributions are invested in a policy issued by an insurer) it may, in practice, be impossible to change the investment strategy or to provide the information to members that is required, for example, when preparing the trustees' annual statement to members (often referred to as the "chair's statement").

It is often said that winding up a DC scheme is a straightforward process when compared with the process of winding up a defined benefit pension scheme. When considering a small DC scheme with perhaps a handful of active members at most, it can easily seem self-evident that to secure members' benefits and wind the scheme up will be the best outcome for all concerned. However, the decision whether to wind up such a scheme may not be as straightforward as it appears at first sight.

## The winding up process

In February 2019, the Pensions Regulator published its guidance (the "Guidance") on "[Winding up a defined contribution scheme](#)".

The Guidance sets out what the Regulator sees as the four stages of the winding-up process:

<b>Stage 1:</b>	Decide whether the scheme should be wound up
<b>Stage 2:</b>	Prepare for and enter formal wind up
<b>Stage 3:</b>	Secure members' benefits
<b>Stage 4:</b>	Complete the wind up process

The Guidance suggests that Stage 1 will involve considering:

- who has the power to trigger the winding-up of the scheme
- whether it is in members' best interests to wind the scheme up and
- who will meet the costs of the wind-up

It also suggests that Stage 2 would involve a review of the scheme rules (including the power of amendment). We think that the review of scheme rules needs to take place at Stage 1 as the trustees will need to review the rules to answer the questions raised at Stage 1. For example, scheme rules normally set out:

- who has the power to trigger the wind-up – the trustees? the employer? or is it a joint decision? It is essential to understand this to ensure that the winding-up has been triggered by the person with the necessary power under the scheme rules in the way required by the scheme rules
- who bears the costs of administering the scheme. If it is unclear who will bear the costs of the winding-up, the trustees will want to discuss this with the employer at an early stage and possibly make amendments to the scheme rules to ensure the employer will meet those costs before making the decision to wind-up
- how members' benefits may be secured on a wind-up. For a DC scheme which existed before 6 April 2006, trustees may expect to be able to secure benefits by transferring members benefits to individual buyout policies which can then be assigned to the individual members. They need to check, however, that this is permitted by scheme rules

It will also be sensible to check at an early stage that the terms of any insurance policy in which scheme assets are invested permits policies to be assigned to individual members or benefits to be transferred to a buy-out policy.



## Deciding whether it is in members' best interests to wind the scheme up

Assuming the trustees are responsible for the decision to wind the scheme up, trustees should obtain legal advice at an early stage in the process. This will enable clarity as to their powers and duties in connection with the decision to wind up the scheme, including the question of whether it is in members' best interests to do so.

Many factors may suggest that winding the scheme up is the best outcome. However, there are some features of DC schemes, particularly older insurance-backed schemes which may not be immediately obvious but which make it difficult for trustees to conclude that it is in members' best interests to wind the scheme up and secure members' benefits outside the scheme.

1

### The nature of the benefits provided

Some older DC schemes are invested in insurance policies that provide valuable guaranteed benefits to members such as guaranteed annual rates of return or that the member's individual fund will be converted into an annuity at retirement at a guaranteed rate. These "guaranteed annuity rates" can be a very valuable benefit for members which may increase their annual income after retirement by several thousand pounds a year.

Where there are guaranteed investment returns or guaranteed annuity rates, it is difficult, if not impossible, to buy a deferred annuity contract now which will reproduce the levels of benefits provided under scheme's policy which may have been issued in the 70s, 80s or 90s.

Where there are guaranteed benefits, trustees may consider that it is better to run the scheme as a closed scheme for the existing members.

On the other hand, sometimes the charging structure of the policy may mean that investment and management charges are eating away the value of members' funds – sometimes even to zero. Where this is an issue, it needs to be addressed urgently in discussions with the relevant insurance company to preserve the value of members' investments.

Because of the potential for a wide range of guaranteed rates of return, it may be necessary to undertake a detailed analysis of individual members' situations because there may not be a "one size fits all" solution that will achieve the best outcome for all members.

2

### Penalties for early surrender of investments

Depending on the terms of the policy the scheme assets are invested in, there could be a loss of a terminal bonus or even an early redemption penalty for cashing in the policy before members retire. This could have a significant effect on the value of members' benefits. The terms of investments need to be reviewed to identify such issues.

3

### Continued accrual for remaining active members

If there are any remaining active members of the scheme, the employer will need to identify a suitable alternative pension arrangement. Sometimes, it may be attractive to transfer accrued benefits over to the new pension arrangement as well as future accrual. However, the same considerations apply to a potential transfer of the benefits to another pension scheme.

In addition, if benefits are to be transferred to a DC master trust or group personal pension plan, there may be a change in the charging structure. In an occupational DC pension scheme, annual management charges may be quite low with the employer paying the bulk of the ongoing administrative and governance costs. From the employer's point of view, the opportunity to reduce ongoing costs may be a driver for transferring any remaining active members to a contract-based arrangement with an external provider. However, contract-based arrangements may have a higher annual maintenance charge which is deducted direct from members' funds. A proposal to transfer the accrued funds of active members from an occupational DC scheme to a contract-based DC scheme with higher member charges may, therefore, be problematic for trustees because of the effect of the higher charges on accumulated funds.

Finally, there is an issue which is a concern for trustees rather than members but which underlines the need to consider members' best interests fully as soon as possible, with the benefit of early legal advice. Under sections 73 and 74 of the Pensions Act 1995, when winding up a defined benefit pension scheme, trustees have the benefit of an automatic statutory discharge from any future liability to provide benefits in respect of a member, provided they have arranged for the benefits to be secured in a way that is provided for in legislation. However, this statutory discharge only applies to defined benefit pension schemes. The trustees of defined contribution schemes do not have the benefit of a statutory discharge. This means that it is all the more important that they ensure that members' benefits are secured on a basis that replicates the benefits provided under the scheme rules.

This article highlights a few of the key issues trustees and employers may need to address when considering winding-up a DC pension scheme.

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