

PENSION SCHEMES ACT 1993, PART X
DETERMINATION BY THE PENSIONS OMBUDSMAN

Applicant	Mr John Hadland
Scheme	Babcock International Group Pension Scheme (the Scheme)
Respondent	Babcock Pension Trust Limited (the Trustee)

Subject

Mr Hadland's complaint is that following a change of the rules of the Scheme, the commutation factor and annuity rate is different. He says that the factor and the rate would essentially be the same if the administration charges were not paid out of the members' funds.

The Pensions Ombudsman's determination and short reasons

The complaint should not be upheld against the Trustee because the rules have been correctly applied.

DETAILED DETERMINATION

Material Facts

Background

1. Mr Hadland joined GEC, and the GEC Plan, in 1986. The ownership of the relevant part of GEC changed to Alstom, then to Alstec and the current owner is Babcock International. As a result of these changes his membership changed from GEC Plan to the Alstom Pension Scheme, then to the Alstec Pension Scheme and finally to the Scheme. The Alstec Pension Scheme merged with the Scheme in July 2008.
2. Both the Alstom Pension Scheme and the Alstec Pension Scheme contained a defined benefit section and a defined contribution section. The defined contribution section known as the Additional Benefits Scheme (**ABS**) was essentially an arrangement for members who wished to make additional voluntary contributions (**AVCs**).
3. The pension at retirement under the defined benefit section is based on a formula taking into account the member's pensionable salary and pensionable service completed at the date of retirement. Under this section, the member has the option to give up, i.e. commute, a part of his/her pension for a tax free lump sum. In converting pension to a lump sum a commutation factor is used.
4. The ABS, being a defined contribution arrangement, resulted in a fund at retirement, part of which could be taken as a tax free lump sum. The fund that remained, after deducting any lump sum that may be taken, was converted to a pension using an annuity rate as decided by the trustees to the scheme after consulting the actuary to the scheme. However, the trustees had the option to secure the pension with a third party insurer if the insurer's annuity rate was better than the rate recommended by the actuary.
5. After 30 November 2003, under the Alstec Pension Scheme, members could no longer make AVCs to the ABS. Instead members had to contribute to a separate AVC arrangement (the **AVC Scheme**). Like the ABS, a tax free lump sum could be taken at retirement under the AVC Scheme. However, unlike the ABS, the remaining fund is used to secure an annuity with a third party insurer.
6. Relevant rules of the schemes concerned are contained in the Appendix to this document.

Relevant facts leading to the complaint

7. A members' guide to the Alstom Pension Scheme dated August 1999 gave, on page 13, examples of the annual pension that a member would give up for £10,000 cash at five year age intervals from 50 to 65 for males and females. On page 15 it gave examples of the amount of pension that could be bought with contributions under the "Additional Benefits Scheme" at the same age intervals. The figures were the same in each case. On both pages the booklet said the figures were "based on the financial conditions applying at the date of this booklet". Each table had a note beneath it which said, "Please note that these rates are for illustration only as the actual rates are reviewed regularly to reflect changes in market rates of interest."
8. As mentioned above, at the time of the booklet it was possible for members to use their fund in the ABS to buy pension within the Alstom Pension Scheme, based on annuity rates recommended by the actuary. That option is not now available in the Scheme; instead the fund must be used to buy an annuity on the open market.
9. On 29 April 2008 all members of the Alstec Pension Scheme were sent a consultation notice informing them of the proposed merger and inviting all active members to join the Scheme. Members were informed that if they did not join the Scheme, no further benefits would accrue under the Alstec Pension Scheme and they would be treated as leaving the Alstec Pension Scheme on 30 June 2008. Mr Hadland joined the Scheme.
10. Mr Hadland is a member under the Alstec DB Members Section of the Scheme and has built up a considerable fund in the ABS.
11. In July 2012 Mr Hadland made a complaint to the Trustee about the changes to the commutation factor and the annuity rate used under the Scheme. He says that under the GEC Plan, and subsequently under the Alstom Pension Scheme, the annuity rate was the same as the commutation factor as shown on the annual pension statements. He says that he has evidence that commutation factors and annuity rates would be commensurate and has referred to some of it in support of his claim. Most of the evidence dates from before 2006 and comes from notices, announcements and forecasts rather than from the Rules.

12. Mr Hadland's complaint was dealt with under stage one of the Scheme's internal dispute resolution procedures (**IDRP**) and he was given the following decision on 10 December 2012:

"It does appear from the Alstom Pension Scheme/Additional Benefit Scheme (ABS) booklet dated August 1999 presented by you that the factor used to convert ABS funds into a pension in the scheme was the same, at the time, as the commutation factor used to determine the amount of scheme pension to be given up in exchange for tax-free cash. However, I can see nothing in the booklet or other scheme documentation that guarantees this going forwards. The discretion to set these factors under the [Scheme] rules lies with the Trustees, in consultation with the Actuary to the scheme. For any portion of the tax free lump on retirement paid after April 2006 which exceeds the pre-April 2006 HMRC maximum amount, the Company may determine a separate commutation factor. These provisions reflect the corresponding provisions of the Alstec Pension Scheme rules."

13. Mr Hadland asked for his complaint to be considered under stage two IDRP, which the Trustee did, and he was given the following decision:

"Reason 1: Only the text in the Alstec deeds was referred to at Stage 1 rather than referring to actual calculations

It is appropriate to refer predominantly to the formal scheme rules when determining matters under the IDRP because the rules take precedence over all other Scheme literature including explanatory booklets for members. This is explained in the introduction to each Member's explanatory booklet. All calculation methods used and practices followed under the scheme must also be in accordance with the scheme rules. Calculation methods, booklets, other Scheme literature and practice were reviewed as part of the Stage 1 investigation...and were found to be consistent with the rules.

With regard to the calculation basis, the Alstec Pension Scheme Rules and the BIGPS Rules do not set out full calculation methods for commutation or annuity rates. They do not prescribe the basis for determining those rates. I have seen no evidence of any guarantees to members that a discretionary practice for such calculations that may have been adopted by a former scheme would be continued: this is not a right under the rules. The Trustee is satisfied that the calculation basis being applied in each case is correct in accordance with the rules and that the requirements under the BIGPS Rules reflect the Alstec Rules in this respect.

Reason 2: Annuity and commutation rates would be the same if expenses were not paid out of the member's fund

I note your suggestion that the conversion rate would be the same if expenses were not paid out of the member's fund. Whilst you did not expand upon this point, I understand that you are referring to expenses that may be deducted from the member's money purchase account when an annuity is purchased or secured.

Your complaint is that if no such charge were deducted, the commutation and annuity rates would be the same. This is not the case. The Trustee had discretion to set these rates in consultation with the scheme Actuary. The deduction of expenses does not affect the actual annuity or commutation rates, which are determined in accordance with the rules. These rates are determined independently of each other. I have found no evidence that your suggestion is correct.”

Summary of Mr Hadland’s position

14. The Trustee appears to acknowledge that benefits now differ from those offered in the past. However, his complaint remains and the change of benefits may not have been made in accordance with the Trustee’s duty to act in the members’ best interests.
15. He does not dispute the fact that actuarial factors may differ from time to time. There may have been reasons why the Trustee might be advised to depart from parity, but there has been no statement to members that there has been a loss of this benefit.
16. It was only stated in the more recent announcements that notices and estimates may be overridden by the rules. This might always have been the legal situation but he cannot understand why the Trustee would deliberately allow announcements, calculations or estimates not in accordance with the rules.
17. If expenses are not deducted, a member is unlikely to want to take the ‘open market option’ where, he understands, typically 2% is deducted from a fund. The claim that a third party insurer sets the annuity rate is not compatible with statements that the scheme actuary advises the rates and that, sometimes, there is a charge of £375 to set up an annuity.
18. There always was the option for members to take the ‘open market option’. Members with life threatening conditions might have secured a better annuity rate through the ‘open market option’ route, but in other circumstances the annuity rate used under the Scheme was more generous as there were no charges.
19. He was advised that the funds from ABS and AVC Scheme are added together at retirement. He would therefore expect the Trustee to offer a generous annuity rate for the total fund even though the annuity rate under the Scheme applies only to the ABS.

20. If an annuity was to be secured with a third party insurer, he would expect the annuity rate to be affected by administration charges unless these are paid by the company or the Scheme.
21. He is not familiar with all the factors that the Trustee and Scheme actuary take into account. If the rates are not affected by administration expenses what other influences, other than actuarial factors, might there be and have those factors changed since 2006?
22. If he took an open market option, because of his wife's and his own health conditions, he would expect the third party insurer to deduct its expenses or commission. Similarly there would be an annual fee if a draw-down facility is used, if allowed.
23. There may not be promises that discretionary practice, benefits and calculations would be continued, but continuity was always promised each time the scheme was transferred with the change in employer.
24. He still does not understand why the benefits should not be commensurate, especially if the Trustee was to use the same third party insurer to buy the benefits for both the defined benefit section and the defined contributions section.

Summary of the Trustee's position

25. The Rules have never contained any promise or requirement that the defined benefit commutation factor and the rate for converting the funds from AVCs and ABS to pensions would be commensurate with each other.
26. The Rules have never specified set commutation factors or annuity rates. There has been no change to the Rules that have directly altered either of them.
27. There has always been an element of discretion in the setting of the commutation factor; the annuity rate for the ABS benefits has always been subject to a similar discretion; and the annuity rate applicable in respect of AVCs has always been dependant on the annuity rates available from the third party insurer with whom those benefits are ultimately secured.
28. The booklets, announcements and benefit illustrations make it clear that any examples or illustrations given reflect market conditions at the time and are subject to change.

29. They have acted in accordance with the Scheme's governing provisions and law in the setting of commutation factors, the setting of annuity rates for the ABS benefits and the purchase of annuities in respect of AVC benefits.
30. In terms of the deduction of expenses from AVC and ABS benefit funds, under the Rules expenses may be deducted from the member's money purchase account when an annuity is purchased or secured. In practice, no deduction of any expenses is made when an annuity is purchased or secured. The only charge applying to these benefits is the annual management charge deducted whilst the funds are invested.
31. Mr Hadland's assertion is not correct that if no such charges were deducted the commutation factor and annuity rate would be the same. The expenses have no effect on the actual annuity rate and commutation factor. These are determined in accordance with the Rules and independently of each other. Commutation factors and annuity rates are subject to different influences and actuarial considerations.
32. The commutation factors and annuity rates set out in the illustrations in the members' explanatory booklets are examples only, and represent the market conditions at a specific point in time. As routinely noted in the explanatory booklet for both the defined benefit and money purchase sections under which Mr Hadland had accrued benefits, the commutation factor and annuity rates used in the illustrations cannot be guaranteed in any way. The explanatory booklet also confirmed that where there is a disparity between the members' literature and the Rules, the Rules will take precedence.
33. It was also made clear in all illustrations and benefit statements provided to Mr Hadland that the commutation factors and annuity rates are illustrative only and that the actual factors will depend on circumstances at the time he retires.

Conclusions

34. I have found some of Mr Hadland's arguments a little hard to follow. But at heart, there is also nothing in the Rules or the rules of the related schemes (i.e. the Alstom Scheme and the Alstec Scheme) which states that commutation factors and annuity rates should be commensurate. In addition, there is nothing in the Rules to say that the administration charges under the Scheme would have a direct effect on commutation factors.

35. Annuities in respect of the benefits under the ABS and the AVC Schemes are secured with third party insurers and therefore any administration charges under the Scheme will have no effect on annuity rates. A third party insurer may apply its own charges for setting up an annuity, but this will be reflected in the amount of the annuity that is secured and not affect the administration charges under the Scheme. If Mr Hadland means that because there are no provider charges in the Scheme, third party insurer's rates should be less attractive, that does not necessarily follow. Other factors are relevant, such as how much annuity business of a particular kind the insurer wants from time to time.
36. Mr Hadland says that he was informed that at retirement the funds from the ABS and the AVC Scheme are combined. Under the ABS, the Trustee has the option to secure an annuity with the fund, after any tax free cash sum has been taken, either with a third party insurer or by applying the annuity rate under the Scheme. So it is possible that the funds could in effect be merged if the annuity rate offered by a third party insurer is better than the annuity rate under the Scheme. But I think Mr Hadland is arguing that combined funds could provide better annuities in the Scheme. Even if that were true it would not mean that the Trustee had to offer such an annuity.
37. The Trustee accepts that in the booklet dated August 1999 for the Alstom Pension Scheme the annuity rate used to convert the ABS fund to a pension was the same as the commutation factor used to determine the pension given up in the defined benefit section for a tax free cash sum. However, the Trustee correctly points out that there is nothing in that booklet or in the Rules which states that the annuity rate and commutation factor will remain unchanged in future.
38. Mr Hadland says he is unable to understand why the Trustee would allow calculations and estimates to be shown in the Scheme literature that are not in accordance with the Rules. But the figures given could not have been anything other than estimates, and being clearly identified as such, there could be no objection to them.
39. Mr Hadland says that while he accepts that actuarial factors may differ from time to time and there may be reasons for not having parity between the commutation factor and the annuity rate, in his view members should have been informed of any changes. The Rules state that the commutation factor is

‘calculated on a basis certified as reasonable by the Actuary’. The Rules do not specify what the commutation factor or the annuity rate may be; commutation factors are reviewed from time to time by the Trustee and annuity rates are dependent on whether the fund arises from the ABS (in which case it is the better of the rate decided by the Trustee or the best rate offered by a third party insurer) or the AVC Scheme (in which case it is the best rate offered by a third party insurer). The Trustee would be remiss in its duties if it did not review the commutation factors and would not be expected to continually adjust this factor to match the annuity rate of a third party insurer, which is based on the insurer’s circumstances (e.g. the type of market the insurer wishes to be in, economies of scale etc). The Trustee may inform members of the new factors, but there is no requirement to do so.

40. Mr Hadland states that if the administration charges were not paid out of the member’s fund, the commutation factor and the annuity rate would essentially be the same. The member’s fund to which Mr Hadland alludes relates to the ABS and AVC funds and not the defined benefits section. As the commutation factor relates to the defined benefits section, charges do – as the Trustee says, appear irrelevant.
41. Essentially the question for me is whether the Trustee has applied the rules correctly and, where judgment is to be exercised, whether it has done so reasonably. I find that it has met both tests. I am unable to find that there has been maladministration on the part of the Trustee and consequently do not uphold Mr Hadland’s complaint.

Tony King
Pensions Ombudsman

28 November 2014

APPENDIX

Provisions of the rules of the Scheme and earlier related schemes

The Alstom Scheme Deed and Rules:

Clause 23 (Expenses of Administration)

“Each of the Employers shall pay such part if any as the Trustee determines of the costs, charges and expenses (other than stamp duties and broker’s fees and other expenses of or in connection with the investment or realisation of the investments of the Fund which duties, fees and expenses shall be paid out of the Fund) incurred in connection with the Scheme.”

Rule 4.6 (Commutation of Member’s Pension) in Schedule I

“...Commutation...shall be effected by the payment...of such lump sum as is determined by reference to tables prescribed by the Trustee for that purpose...”

Rule 4.1 (Benefits on or after attaining Pension Age) in Schedule II

“...Provided that...the rate at which the Benefit Value shall be applied to pension shall be determined by the Trustee in manner approved from time to time by the Actuary...”

The Alstec Scheme Rules:

Clause 5.4 (Expenses)

“All costs, charges and expenses of or in connection with the Scheme or the Fund shall be paid out of the Fund (including, without limitation, any stamp duties, broker’s fees...to insure against liabilities arising from time to time and during or after termination of the Scheme).”

Clause 12.3 (Additional Benefits Scheme)

“12.3.1 Prior to 1 December 2003 a Defined Benefit Member...in Pensionable Service may elect, in such form as may be prescribed from time to time by the Trustees, to make voluntary contributions to the Additional Benefits Scheme (which forms part of the Scheme) and may increase, decrease or discontinue such contributions...”

12.3.4 The additional benefits payable in respect of the Defined Benefit Member’s voluntary contributions to the Additional Benefits Scheme shall be determined by the Trustees...and may include:

(a) on the Member’s retirement on or after Normal Retirement Date, a lump sum or pension payable to the Member, and a pension payable to his Spouse...

12.3.5 The amount of such additional benefits shall be determined by the Trustees (after consulting the Scheme Actuary or the Insurance Company or other organisation with which they may be secured) on a basis which is reasonable, having regard to the amount held under the Member’s retirement credit account...”

Clause 12.4 (Additional Voluntary Contributions)

“12.4.1 A Defined Benefit Member may make voluntary contributions to the Scheme and may increase, decrease or discontinue such contributions,...in order to provide additional benefits payable in the form of pensions or lump sum benefits as agreed between the Member and the Trustees.”

Clause 13.6.4 (Commutation)

“The Trustees shall calculate the amount of pension forgone to provide a lump sum...as follows:

(f) in respect of that portion of any lump sum benefits so payable under the Definitive Deed of up to the maximum lump sum that could have been paid within Inland Revenue Limits as at 5 April 2006, the commutation factors for conversion of pension to cash shall be calculated on a basis certified as reasonable by the Scheme Actuary;

(g) to the extent that benefits so payable in lump sum form from and after 6 April 2006,...may exceed the maximum amount specified in Clause 13.6.4 above, the commutation factors for conversion of pension to cash shall be determined by the Principal Employer from time to time (after consulting an actuary).”

The Babcock International Group Pension Scheme rules:

Rule 37 (Costs and expenses) in General Rules

“37.1 All liabilities fees and expenses properly incurred in the execution or purported execution of the trusts of the Scheme or otherwise properly incurred in relation thereto shall be met out of the assets of the Fund.

The Trustees may from time to time agree with the Principal Employer that the Employers will bear such of the liabilities, fees and expenses of managing and administering the Scheme as the Principal Employer shall, in its absolute discretion, decide. The Principal Employer and the Trustees may agree that the payment for such liabilities fees or expenses shall be included in the Employers contributions payable in accordance with Rule 7.1 or that it be in addition to those contributions or that it be partly by one such other such method.”

Paragraph 17.3 (Lump Sum Option) in the Alstec DB Members Section

“17.3 The Trustees shall calculate the amount of pension forgone to provide a lump sum in accordance with paragraph 17.1 as follows:-

17.3.1 in respect of of that portion of any lump sum benefits so payable under the Rules of up to the maximum lump sum...the commutation factors for conversion of pension to cash shall be calculated on a basis certified as reasonable by the Actuary;

17.3.2 to the extent that benefits so payable in lump sum form from and after 6 April 2006,...the commutation factors for conversion of pension to cash shall be determined by the Principal Employer from time to time (after consulting an actuary).”

Paragraph 8.1 (Additional Benefits Scheme)

“8.1.1 Prior to 1 December 2003 an Alstec DB Member in Pensionable Service could elect, in such form as had been prescribed from time to time by the Trustees, to make voluntary contributions to the Additional Benefits

Scheme(which forms part of the Scheme) and could increase, decrease or discontinue such contributions...

...

8.1.4 The additional benefits payable in respect of the Alstec DB Member's voluntary contributions to the Additional Benefits Scheme shall be determined by the Trustees...and may include:

(a) on the Member's retirement on or after Normal Retirement Date, a lump sum or pension payable to the Member, and a pension payable to his Spouse...

8.1.5 The amounts of such additional benefits shall be determined by the Trustees (after consulting the Actuary or the Insurance Company or other organisation with which they may be secured) on a basis which is reasonable, having regard to the amount held under the Member's retirement credit account..."

Paragraph 4.2 (MP Member Balance) in the Money Purchase Section (*Applying to AVCs*)

"The Trustees may in relation to any Member...from time to time determine his MP Member's Balance by reference to the following calculation...by deducting...a due proportion of all investment expenses...any amount...attributable to the cost of annuity broking..."

Paragraph 5.1. (Benefits on retirement)

"...the Trustees must...use the MP Member's balance to purchase an annuity...from an Insurance Company"