

## **RECONCILING CONTRACTED-OUT BENEFITS: A FRAMEWORK FOR ACTION**

### **FIRST STEPS IN DATA RECONCILIATION**

This guidance forms part of a series of notes offering guidance to UK pension schemes on principles for approaching the reconciliation of contracted-out benefits in a pragmatic and proportionate way.

This note is not a definitive guide to the issues involved, nor is it a substitute for legal advice on which any particular pension arrangement may rely. It is intended to assist those in the industry to establish appropriate approaches to dealing with the complexity of addressing reconciliation and rectification issues in relation to contracted-out benefits.

This note is based on current understanding and awareness of HMRC processes as at January 2016 and will be revised and updated as information about further developments becomes available.

#### **Overview**

In principle, schemes should pay members the benefits to which they are entitled under the rules. However, in relation to contracted-out benefits, and in particular guaranteed minimum pensions (GMPs), the complexity of the system and historic data problems are likely to present schemes with considerable difficulty in achieving this objective.

Despite this difficulty, there are significant reasons for schemes which hold contracted-out liabilities to undertake the task of reconciling data for contracted-out benefits sooner rather than later – see our June 2015 Call to Action for more details. Scheme sponsors have a key role to play in supporting this work and determining the appropriate approach to be taken. This exercise can have a positive impact: significant liability reductions and overall cost savings may be possible as a result of reconciliation work.

The first stage of any reconciliation exercise is to understand the potential scope of the problem. This involves:

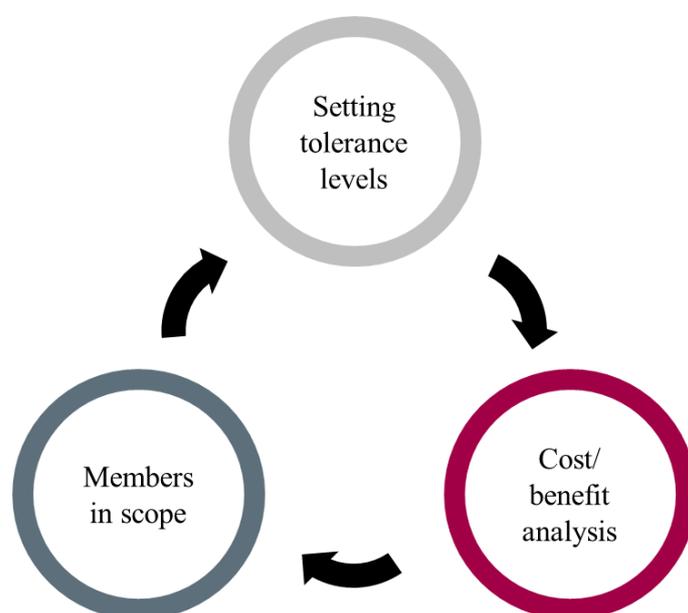
- identifying the extent to which HMRC and the scheme agree on the identities of the members in relation to whom liabilities are held by the scheme, by reviewing data obtained from the Scheme Reconciliation Service (SRS) (or Shared Workspace, for schemes which have already ceased to contract out); and
- considering the likely population in scope for reconciliation of member data and possible subsequent rectification work – this will inform, and will be affected by, any tolerances to be set by the scheme.

The number of scheme members falling within scope of a scheme's reconciliation/rectification exercise – and the cost of undertaking that work – will to some extent be defined by any agreed

scheme tolerances and corrective tolerances the trustees choose to set. Trustees aiming to correct all records for all member categories as accurately as possible will be likely to incur significantly greater costs per member in the course of the reconciliation/rectification exercise than a scheme which uses robust tolerances.

Conversely, the choice of appropriate tolerance levels will depend to some extent on the membership and benefit profile of the scheme; and since reconciliation processes and possible recalculations involve additional costs, the cost/benefit analysis of particular approaches to the overall task, or individual aspects of it, will also be relevant.

All three issues – the scale of the exercise, the appropriateness of tolerance levels, and the cost/benefit analysis of undertaking the work – need to be considered together as interdependent variables to reach an approach which is both pragmatic and appropriate for the scheme and its membership.



This guidance note provides an overview of two aspects of reconciliation activity – member existence checking and member data reconciliation/rectification. It is designed to assist discussions between trustees and scheme sponsors as they determine their approach to reconciling contracted-out benefits. Future guidance will consider issues around rectifying underpayments or overpayments which are identified as a result of the reconciliation exercise.

This guidance has been drafted on the premise that, where there is a discrepancy in the amount of the GMP and the reason for that discrepancy cannot be identified, trustees will typically pay the figure provided by HMRC. However, there may be instances where trustees decide, based on the evidence that they have, that their records are more likely to reflect the correct benefit amount and will therefore choose to use those figures, recognising that their records will not reconcile with those of HMRC. Careful consideration needs to be given before adopting this approach in light of HMRC's proposed notifications to members in 2018 (see below).

## 1. Member level reconciliation

HMRC has identified a variance of up to 30% in member existence records (i.e. its record of membership numbers compared to those reported by schemes registering for the Scheme Reconciliation Service)<sup>1</sup>. Individual schemes may experience a greater or lesser mismatch. An initial member level checking exercise is therefore required. Failing to take this basic step of comparing scheme membership lists to those received from HMRC could mean that a scheme is accepting liabilities in relation to significant numbers of members who may have transferred out years ago, or who may not have been scheme members at all. Conversely, schemes may be expecting contracted-out data for scheme members who do not appear on the HMRC data extract (and who may be incorrectly attributed to a different scheme) and this initial step should seek to resolve these discrepancies too.

HMRC's stated policy is that its figures/records will apply unless the scheme can establish otherwise. From the end of 2018 onwards, HMRC will write to all members who reach State Pension Age from April 2016, informing them of the existence of their GMP rights and naming the schemes in which it believes those rights are held. The exact information to be provided in these letters is still to be determined, but it is crucial to ensure, so far as possible, that the correct members are attributed to the correct schemes before the letters are issued.

For more information on member level reconciliation, see guidance note 2, 'Member level reconciliation'.

## 2. Reconciling member data

### (a) *Identifying reasons for data errors*

Having established the correct class of members, the next stage is to check for discrepancies in the data attached to those members – for example, their earnings data and period of service. This can be difficult, as schemes may not have available data to check members' benefits fully or to correctly restructure benefits back to date of leaving. Common causes for data mismatch include:

- National Insurance (NI) earnings data being incorrect or incomplete;
- GMP data being allocated to the wrong period of service (for example, not correctly split between pre- and post-April 1988 service, so that incorrect increases have been applied);
- spouses incorrectly recorded as pensioners (i.e. false data as to potential contingent beneficiaries);
- missing data following changes of administrator; and
- bulk transfers in or out of the scheme as a result of corporate activity.

Sample testing and discussions with your administrators about historic practices may help to identify areas where bulk solutions could simplify data reconciliation.

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<sup>1</sup> See HMRC Countdown Bulletin 4, December 2014

## Is it simpler just to accept HMRC data?

Following a member existence reconciliation, schemes might consider accepting HMRC's value data in relation to all members for whom the scheme acknowledges liability. This would reduce the costs of investigative and reconciliation work, but does not resolve all issues:

- scheme data would have to be updated in line with HMRC data and payment adjustments considered;
- although discrepancies in many cases may be relatively small, they can become significant additional liabilities (for example, when compounded over time); and
- if HMRC data incorrectly states the GMP, the scheme would remain liable for the correct level of benefit.

Schemes should consider carefully whether accepting HMRC value data is an appropriate solution. If considering this approach, schemes should undertake sampling to determine the significance of value discrepancies in the context of their scheme. Member categories in relation to which value discrepancies are identified as a greater risk in terms of frequency/significance should be examined in greater detail. In addition, trustees should consult their actuary and consider the potential funding implications of taking this approach.

Schemes may also wish to consider a differentiated approach if this is appropriate – for example, adopting HMRC's data for some member categories but not others, depending on the relative reliability of scheme versus HMRC data.

### (b) *Setting priorities*

Schemes may wish to proceed with data reconciliation on a prioritised basis.

For pragmatic reasons, it may be helpful to ensure that data is reconciled for members approaching age 55 and up to State Pension Age as a priority, because these members will shortly be able to request estimates of their entitlements under the new single-tier state pension. Those estimates will include (for members who have had any period of contracted-out service) a statement of the individual's Contracted-Out Pension Equivalent (COPE). This represents the reduction in the single-tier state pension resulting from all periods of contracted-out service; the statement indicates that this will be paid by the individual's private workplace or personal pension scheme(s) instead of by the state. Further information about these statements and the accompanying leaflet sent to members is available on the Gov.uk website.

Even though members may not be able to identify discrepancies in the COPE amount shown in their state pension estimates, schemes may wish to prioritise their work in a way which mitigates the risk of queries arising from inaccurate information about members' COPE amounts.

Evidence from current scheme reconciliation processes has highlighted issues including:

- historic contributions equivalent premium payments not being recorded by HMRC (where this has happened, the member should have been 'bought back' into the state scheme for the relevant period of service);
- trivial commutation payments not being recorded by HMRC (i.e. where the member has already cashed out the relevant benefit from the scheme); and

- member data errors (in some cases, the member's GMP entitlement from the scheme might be lower than the estimate given by HMRC, due to unresolved data errors).

In terms of setting priorities, consideration should also be given to members who are over State Pension Age and in receipt of a pension, as underpayments or overpayments may already be occurring.

(c) *Setting tolerances*

Schemes may wish to consider applying thresholds to determine whether it is appropriate to investigate data differences or make corrective payments. For example, a scheme might consider establishing one or more of the following:

*Reconciliation tolerances*

- A minimal **rounding tolerance**, within which no differences are investigated and no changes made to member records or pensions in payment. Rounding differences may arise due to HMRC operating rounding on a weekly basis, compared to a scheme operating rounding on a monthly basis.
- An agreed **scheme tolerance or investigative tolerance**, such that, if the GMP value provided by HMRC is within the lesser of £x per week or y% of pre-97 scheme benefit, it may not be cost-effective to investigate further. In these cases, a scheme may decide to accept HMRC data for the purposes of reconciliation without further investigation. Scheme records are adjusted accordingly, leading to a potential need to rectify benefit payments.

Cases lying outside the agreed scheme tolerance would need to be investigated and resolved, and would then form part of the later rectification exercise.

*Rectification tolerances*

- Trustees may consider whether to apply **rounding tolerances**, in cases where differences are so minimal as to outweigh the cost of any correction exercise.
- **Corrective tolerances** may be considered in relation to rectifying member payments where discrepancies which fall outside any rounding tolerance have become apparent through the reconciliation process. For instance, where overpayments have been identified, trustees will need to decide whether to seek recovery, write off overpaid amounts but pay the correct benefits going forward, or augment benefits to the level which has been in payment – it can be helpful to establish parameters for different types of corrective action.

We recommend that you read guidance note 3, 'The role of tolerances in reconciliation and rectification exercises', for more information on practical issues around setting and operating tolerances. Future guidance on rectification processes will look in more detail at the issues around underpayments and overpayments, and setting appropriate corrective tolerances.

### Approaches to establishing tolerances may differ depending on factors including:

- whether the tolerance applies to investigating data discrepancies or correcting benefit payments;
- whether the arrangement is in the public or private sector;
- whether the difference represents an underpayment or an overpayment (taking into account the potential implications of systemic issues, length of payment, etc); and
- proportionality (including the relative value of the GMP to the overall benefit).

Schemes should be aware that the Pensions Regulator's suggested £2 a week tolerance for GMP reconciliation applies to the separate context of winding-up and does not offer a guide as to the appropriate level(s) of tolerance which any particular scheme might decide to establish for GMP reconciliation/rectification. Schemes should seek advice from their legal advisers and administrators to help determine the most appropriate scheme-specific approach.

It should also be noted that there is no legal basis for deciding to underpay benefits, so schemes would remain at risk of potential challenges/member complaints if they decide not to correct known underpayments.

Your administrators will be able to provide more specific information to inform discussions at the initial stages by providing relevant data about different membership groups and benefit levels, as well as indicative costs based on different approaches.

### **3. Working with tolerances**

In cases which fall within any agreed scheme tolerance being applied by the scheme to a particular member category, data may be conformed to HMRC records and the scheme should then go on to consider dealing with any corrections accordingly.

Where comparison with HMRC data reveals a difference outside the scope of any agreed scheme tolerance applied, the scheme will need to provide evidence to support its data to HMRC and the issue will be resolved either:

- by HMRC reconciling its records to scheme data (in which case no further action is required);
- by the scheme deciding, after investigation, to reconcile its records to HMRC data (in which case further corrective action may be required); or
- by the trustees of the scheme deciding, after considering the evidence, that their records are more likely to reflect the correct benefit payable than those of HMRC.

Note that the last of these options could lead to issues later on, such as problems buying out benefits and member complaints where the scheme is not paying the amount that HMRC records indicate is owed.

Reconciliation/recalculation work can be undertaken with different levels of precision. For example, where trustees have decided to accept HMRC's figures for a member who is already in receipt of their GMP, schemes may wish to consider whether it is appropriate to correct data back to GMP age only, rather than going back to the member's date of leaving. This may depend on the extent of GMP reconciliation carried out when the member reached GMP age – but even small differences can result in large aggregate overpayments.

**Example: Scheme A had a large group of post-SPA pensioners for whom:**

- GMPs posted at SPA were within 3 pence per week of HMRC's figures, but
- when current GMPs in payment were discounted back to SPA, pensioners were being overpaid by £1 per week or more.

The aggregate net overpayment by the scheme was estimated at £1.1 million per year.

Trustees should bear in mind that failure to carry out full reconciliation now could create future problems in relation to GMP equalisation or future de-risking activity. Schemes may need to confirm through sample testing whether a more restricted approach would be reasonable in the context of their historic practices.

Some schemes and sponsors have found that greater accuracy in the GMP reconciliation process is worth paying for, in light of the impact of corrections on scheme liabilities – again, your administrators can help you assess the cost/benefit analysis of different approaches.

#### **4. What about post-1997 service?**

Much of the discussion in the industry currently centres on GMP reconciliation, as this is the most complex part of the problem. Should schemes also verify post-April 1997 data? The relevance for individual members (and HMRC) is that if the dates of a member's contracted-out service are recorded incorrectly, this will affect the member's foundation amount under the single-tier state pension.

Discrepancies in post-1997 data may appear to have a less direct impact for schemes, but it is important to remember that, based on our current understanding, the information HMRC sends to members will refer to service dates and schemes in relation to both pre- and post-April 1997 service. If schemes fail to verify post-April 1997 data, they may find that members are incorrectly informed about their period of membership of, or deferred rights under, the scheme.

For members with post-1997 service only, key data elements such as a member's date of birth, date of leaving, surname and national insurance number should be checked; for these members, a date of leaving in the correct tax year is acceptable (it is not necessary to reconcile to the precise date). Members who have contracted-out service both before and after April 1997 will have a single record reflecting both periods of contracted-out service.

## **5. Working with your administrators: practical tips**

As highlighted in this and our other guidance notes, it will be important to work with the administrators undertaking your GMP reconciliation and rectification project to establish the scale of the exercise, any tolerance levels to be applied, and the costs involved.

Typically, administrators will split a reconciliation exercise into stages and provide an estimated cost and scope for each stage. It is important for trustees to understand precisely what work is being agreed before proceeding.

Schemes should check that all the correct scheme contracting-out numbers (SCONs) are included as part of the request to HMRC's Shared Workspace or SRS. Checking the SCONs at an early stage may avoid, or lead to early resolution of, a large number of membership queries, particularly where there is a history of corporate activity.

Members may move from active to deferred or pensioner status between the date when SRS data for the deferred and pensioner members is obtained and 6 April 2016. It is therefore likely to be helpful to request a second data file of deferred and pensioner members immediately before 6 April 2016. We understand that HMRC is currently considering supplying this data automatically, so you may wish to check the current position before making your data request.

As other schemes progress their reconciliation exercises, your scheme may receive notifications about changes to membership data (for example, in relation to members who transfer between schemes before 6 April 2016). Schemes should ensure that any such notifications are passed on to the team dealing with the reconciliation exercise as soon as possible. Notifications will not be provided by HMRC in relation to members who transfer on or after 6 April 2016.

## **6. Schemes which cease to contract out on 6 April 2016**

Schemes which cease to contract out on 6 April 2016 will not receive data in relation to members who are active at that date until HMRC has conducted its closure scan of all remaining contracted-out schemes as at April 2016. This is due to take place in December 2016 and this data will then be provided to schemes for reconciliation (by the same target date of December 2018 as for other data).

Data for members who change category to deferred or pensioner status in the interim period may be obtained on an individual basis through HMRC's separate GMP service.