

THE ROLE OF TOLERANCES IN RECONCILIATION AND RECTIFICATION EXERCISES

Trustees embarking on the process of reconciling and rectifying contracted-out member data will need to establish a pragmatic and cost-effective approach. Budgets are likely to be limited – both in time and cost terms – and the resources required to reconcile all differences ‘to the penny’ may in some cases far outweigh any resulting benefit.

In order to avoid spending disproportionate resources reconciling potentially immaterial differences between pensions administration and HMRC figures, trustees may wish to consider using ‘tolerances’ – that is, limiting the investigative or corrective work to be undertaken by administrators by accepting minor differences without further investigation.

What is a tolerance?

Different types of tolerance may apply at different stages of the reconciliation and rectification process.

Reconciliation tolerances

- **Rounding tolerance** – rounding differences may arise due to HMRC operating rounding in relation to increases to contracted-out rights on a weekly basis, compared to a scheme operating rounding on a monthly basis. A rounding tolerance would be set at a very low level, for example up to a maximum of 5 pence per week. Where schemes operate a rounding tolerance, they tend to accept GMP differences within the agreed tolerance without investigation and no changes are made to member records or pensions in payment within that tolerance.
- **An agreed scheme 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. This type of tolerance is designed to filter out cases where it is more cost-effective to simply accept HMRC data than to investigate discrepancies. Where the tolerance applies, HMRC data is accepted for the purposes of reconciliation without further investigation. Scheme records are then reconciled to HMRC data, which may create an apparent under- or overpayment to the relevant member, which would need to be addressed at the rectification stage.

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

Often trustees will want to model the impact of applying different tolerance levels, and may use an agreed scheme tolerance as a tool to identify and correct priority cases first (e.g. larger discrepancies or more sensitive cases), working towards lower priority cases over time.

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 have become apparent through the reconciliation process which fall outside any rounding tolerance. 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.

Future guidance on rectification processes will look in more detail at the issues around underpayments and overpayments, and setting appropriate corrective tolerances.

Finding the right level of tolerance for your scheme

Schemes which are winding up or entering PPF assessment typically apply a £2 per week agreed scheme tolerance, in line with guidance previously issued by the Pensions Regulator for reconciling GMP calculations in these circumstances.

It is important to note that this guidance does not provide authority for using a £2 a week tolerance for ongoing schemes. The effect of an under- or overpayment may be compounded over years or decades in payment and may make a significant difference for some pensioners, either in absolute or proportionate terms. Ongoing schemes require much more precision than schemes in winding up and may, for example, look to apply a tolerance of just a few pence per week.

The key is to establish tolerances that are appropriate for the scheme, its membership profile (in size and benefit terms) and the relative impact of rectifying contracted-out benefits. Setting tolerances by reference to percentages of member benefits, rather than in pounds and pence terms, may be more appropriate for some schemes.

A higher tolerance (for example £5 per week) would mean that resources (both time and cost) could be dedicated to investigating fewer cases, and potentially to dealing with more significant discrepancies. It increases the potential for accepting incorrect data, where investigations would have shown that the scheme data was in fact correct.

Conversely, applying very low tolerance levels (i.e. a high degree of accuracy) may be very labour-intensive and expensive, potentially without a proportionate return for the scheme/members involved.

Schemes which are looking towards buy-out or winding up should also bear in mind the degree of certainty sought by insurers, which may not accept a £2 per week tolerance as being sufficiently accurate.

Historically, common practice has been to undertake a measure of scheme reconciliation so that, by examining any data differences discovered, trustees have a better idea of the potential impact of any particular tolerance level they decide to apply.

Industry experience to date has highlighted particular issues relating to members who have transferred into a scheme. Administrators will often recommend that transfer-in cases should be checked on an individual basis to test whether the correct forms were provided at the point of transfer, and that revaluation rates have been provided and applied correctly. It is possible that neither the GMP held by the administrator nor the figure provided by HMRC is correct and that the only way the correct GMP can be established is by reviewing the member's file.

Rounding tolerances: points to note

It is important to understand the potential impact of rounding tolerances for different categories of member. In relation to members over state pension age who are in receipt of their pension, any rounding difference remains constant; however, for deferred members the data supplied by the Scheme Reconciliation Service (SRS) is provided as at the member's date of leaving, and will be different when revalued to the member's GMP age. A difference of a few pence at the date of leaving is likely to become a more significant difference once this process is undertaken; schemes should consider whether it is appropriate to apply a rounding tolerance to deferred members in the same way as to pensioners. A more accurate comparison would be obtained by taking scheme and HMRC data as at the date of leaving, revaluing both to GMP age and then comparing the difference. Schemes may wish to take a pragmatic approach, including seeking legal advice on this issue, together with advice about the funding impact of undertaking any additional calculations required.

SRS data will show revaluation rates as 's148', 'limited' or 'fixed'. However, for schemes which have ceased to contract out before 6 April 2016, data supplied by HMRC's Shared Workspace does not automatically show the revaluation rates assumed within HMRC's calculations. If the rate applied is incorrect, it may be the case that any discrepancy in fact falls outside the rounding tolerance and should be treated appropriately.

Even where schemes accept GMP differences within an agreed rounding tolerance, normal practice is that any service date discrepancies which are shown up by the reconciliation exercise should be investigated (since, if corrected, any discrepancy may fall outside the agreed tolerance).

How your administrator can help

Setting the right level of tolerance, at either the reconciliation or rectification stage, is an important decision for the trustees and it is also important that they have an audit trail showing the considerations that they have taken into account in reaching that decision. Administrators have an important role to play in helping trustees through the decision-making process.

The type of information trustees will typically seek from their administrator includes the following:

- the number of members inside and outside prescribed tolerance levels;
- modelling data showing the impact on those numbers of applying different tolerances, or of applying different tolerances to particular categories of member;

How your administrator can help

- modelling data showing the number of members inside and outside the suggested tolerance depending on whether the tolerance is set at GMP age or date of leaving; and
- the potential impact on members' benefits, by providing some example calculations – an apparently low tolerance may have a material impact on individual members' benefits. For example, application of a £2 per week tolerance to someone on a £500 a year pension is potentially of greater materiality than if the member's pension is £20,000 a year. For most schemes, it is unlikely to be practicable to consider the position for every individual member, but it can sometimes be helpful to understand the impact of a tolerance level in relation to the benefits being paid to relevant members.

Trustees should also consider the impact on administration costs of the work involved either at the reconciliation or rectification stage, to ensure that the cost to the scheme is proportionate to the benefit to members.

Practical issues

- Ultimately, whether to set tolerances, and at what level, is the trustees' decision. Trustees should bear in mind the circumstances for their particular scheme, their attitude to risk, and the implications of their decision for the interests of members generally. Trustees are strongly advised to consider appropriate evidence from their administrators so that they have all relevant information to hand, and to take legal advice in appropriate cases, before agreeing any scheme specific tolerance.
- Trustees may need to be able to justify why they have accepted HMRC data rather than applying the scheme's data (and vice versa), for example if a member were to challenge changes to their benefit data.
- Trustees may consider applying a range of different tolerances to different categories of member (subject to overall considerations of fairness and appropriateness) taking into account quality of scheme records, availability of company records and available budget.
- Trustees will also need to consider how a tolerance level is applied in practice in the corrective process – as mentioned above, deciding to apply a tolerance to discrepancies shown as at members' date of leaving will yield different results to applying the same tolerance as at members' GMP age. Again, trustees will need to work with their administrators to identify what tolerance level is appropriate for any particular membership category, and how it should be applied in the reconciliation process.
- This note focuses on tolerances in relation to GMPs, but trustees also need to consider if any tolerance will apply in relation to the contracted-out dates for members with post-97 contracted-out membership. As an example, some schemes adopt a tolerance such that where there is a discrepancy between HMRC and the record held by the administrator in relation to either the contracted-out start or end date, where the dates held are within the same tax year, HMRC's date will be accepted.

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.