

Contract-Based and Trust-Based Defined Contribution Pension Schemes

This overview focuses on the key aspects of defined contribution (DC) pension arrangements, highlighting the differences where applicable.

At the top level, both types of scheme aim to build up a fund for each member to be used to provide benefits, typically at retirement or earlier death. The main determinants for the benefits that will eventually be produced are the amounts of contributions paid into the scheme, the investment growth achieved over the period, the expenses deducted and the prevailing financial conditions at the time the funds are required.

Although nearly all DC schemes have, since 6 April 2006, been classified as HMRC Registered Pension Schemes, the majority fall into the following distinct categories.

MAIN TYPES OF DC SCHEME

Trust-based Schemes (taken as Occupational Pension Schemes for the purposes of this overview)

These can be either self-administered (either in-house or by a third party administrator) or insured (where an insurance company provides some or all services within the terms of a group policy).

Some providers have established a Master Trust, which companies can join to benefit from economies of scale as the provider covers all the administration and compliance issues. Each joining employer is, of course, free to set the contribution levels for itself and its employees.

Contract-based Schemes

There are a number of varieties of Contract-based pension arrangements although all have the common feature of being established by a contract between the individual and the provider. Even where there is a group arrangement sponsored by an employer, the scheme exists as a series of individual contracts.

- **Personal Pension Plan (PPP) / Group Pension Plan (GPP).** An individual policy, or group of policies, issued by a provider (commonly a life office, bank or other financial institution such as a unit trust provider).
- **Self Invested Personal Pension (SIPP) / Group SIPP.** Similar to PPP / GPP but with much greater flexibility as to which investments can be included under the umbrella of the policy. For

example, a policyholder is able to include in the arrangement direct holdings in unitised funds, stocks and shares, property, etc.

- **Stakeholder (SHP) Policy / Group SHP.** Similar to PPP / GPP but only introduced in 2001 as part of the change in law that required all employers to “facilitate” retirement saving for their employees. Special rules apply, such as a maximum annual management charge but, importantly, employers do not have to contribute.

There are, however, some significant differences in the way that the schemes are established, managed and regulated and the table overleaf compares the main features of the two types of DC scheme.

	<i>Contract-based</i>	<i>Trust-based (OPS)</i>
Contractual Relationship (ignores relationship of Contracts of Employment)	Provider and Employee. There is no contractual relationship between Employer and Provider	None. Trust Law applies with the Employer and Trustee being parties to the Trust, and members being the beneficiaries
Formal Scheme Documentation	Policies prepared by Provider	Legal advisers required to prepare trust documentation
Trustees	Not required, although good practice would be to establish a Governance Committee	Required, including 1/3 rd Member-nominated Trustees or, alternatively, a sole Independent Trustee
Comply with Trust Law	Not required	Required
Regulation	Pensions Regulator and Financial Services Act	Pensions Regulator
Hold formal meetings and maintain records	Not formally required	Required
Scheme accounts	Not required	Formal accounts to be prepared and audited annually (not for wholly insured schemes)

Internal Dispute Resolution Procedures / Risk Assessment / Statement of Investment Principles / Trustee Knowledge & Understanding, etc	Not formally required although comparable documents / procedures could be put in place	Compliance required
Pensions Regulator Levy	None	Yes
Administration	Provider is the administrator	An administrator will need to be appointed (could be insurer)
Scheme expenses	Normally met by Annual Management Charge (AMC) deducted from member's fund(s)	Typically met by the Employer, although AMC could be applied to member's fund(s)
Maximum Annual Management Charge	Yes, for SHP (initially 1% but subsequently increased to 1.5% for first 10 years of contract)	No
Tax relief at source	Contributions paid net of basic rate tax relief. Higher rate taxpayers claim additional relief through self-assessment tax return	Yes, at marginal rate through PAYE
Investment choice	All funds offered by provider	Funds selected by Trustee(s)
Decumulation Responsibility at retirement (Open Market Option must be offered)	Member required to arrange annuity, income drawdown, etc	Trustee(s)
Leavers	After leaving, the relationship is solely between the Provider and the individual	Vested leavers maintained in scheme
Vesting	No refund option (apart from in first month under Auto-enrolment)	Employee contribution refund is normally payable if employee has less than two years membership For those over two years, the funds remain vested in the scheme
Employer Contribution Refunds	No refund option (apart from in first month under Auto-enrolment)	May be payable for non-vested leavers in first two years

Tax-free Cash Sum	25% of Fund	25% of Fund (but members of older schemes could have higher entitlement)
Contracting-out of State Scheme	Yes, under an Appropriate PPP (APPP) but ceases 05/04/2012	Yes, but ceases 05/04/2012
Winding-up	Not applicable	Trustee responsibility
Commission	Not permitted for new contracts after Retail Distribution Review effective 2012	Available