Trinity Term
[2011] UKSC 42
On appeal from: [2010] EWCA Civ 179

JUDGMENT

Houldsworth and another (Respondents) *v* Bridge Trustees Limited and another (Respondents) and Secretary of State for Work and Pensions (Appellant)

before

Lord Walker
Lady Hale
Lord Mance
Lord Collins
Lord Clarke

JUDGMENT GIVEN ON

27 July 2011

Heard on 20 and 21 June 2011

Appellant
Christopher Nugee QC
Jonathan Hilliard
(Instructed by DWP/DH Legal Services)

Respondent (Houldsworth)
Andrew Simmonds QC
Nicolas Stallworthy QC
(Instructed by 3volution LLP)

Respondent (Bridge Trustees Ltd)
Keith Rowley QC

(Instructed by Eversheds LLP)

LORD WALKER (with whom Lady Hale, Lord Collins and Lord Clarke agree)

Introduction

1. This appeal raises a question of some importance on the law relating to occupational pension schemes. The agreed statement of facts and issues ("SFI") sets out three issues, but they are all variations on the same general theme, that is the dividing line, for regulatory purposes, between defined benefit (normally earnings-related) schemes and defined contribution (or money purchase) schemes.

2. The general nature of the distinction between these two types of scheme is familiar, and it may be helpful to start with that (though counsel on both sides properly reminded us that we are concerned with a particular statutory definition, and not with the range of meanings in which imprecise expressions may be used). Under a defined benefit scheme (the commonest variety of which is a final salary scheme) the primary benefit to which a scheme member is prospectively entitled, on retirement at normal pension age, is a pension for life calculated (in a final salary scheme) by reference to the member's pensionable salary at retirement. A typical formula for calculating the pension was N/60ths, where N is years of pensionable service, but today the formula is more often N/80ths. The member pays contributions (typically a fraction, such as 5%, of current pensionable salary) and the employer is under a general obligation to pay the balance needed to provide all the benefits under the scheme. Final salary schemes are therefore also referred to as balance of cost schemes. What the member pays makes an important contribution to the benefit, but the amount of the benefit is not calculated by reference to the amount of the member's contributions, and the risk of a disappointing investment return on the pension fund is assumed by the employer.

3. Under a defined contribution scheme, by contrast, the member's benefit is calculated by reference to the contributions that the member makes, and those that the employer makes in respect of that particular member (for instance the member may pay 4% of his or her current pensionable salary, with the employer matching that with an equal contribution). These contributions, and the investment return on them, are the measure of the member's benefits, and for that reason these schemes are also called money purchase schemes. The member, and not the employer, takes the risk of the investment return disappointing expectations. That is one of the main reasons why large numbers of employers have, since the last years of the 20th century, closed their final salary schemes (either completely or to new entrants) and introduced money purchase schemes.

4. There is a variety of techniques by which, under a money purchase scheme, the amount of the contributions by or for a member, and the investment return on them, are mathematically transposed into quantifying the pension that is the primary benefit that the member expects to receive. Indeed the appellant's case is that some of the techniques (and in particular, those applicable to the voluntary investment planning ("VIP") and MoneyMatch benefits under the scheme that are the subject of this appeal) take the scheme outside the statutory definition of "money purchase benefits" in section 181 of the Pension Schemes Act 1993 ("PSA 1993") as applied for the purposes of section 73 of the Pensions Act 1995 ("PA 1995"). Section 73 provides a statutory order of priority in the winding up of pension scheme but it does not apply to money purchase schemes, and it applies only in a limited way to "hybrid schemes" (under which some but not all of the benefits provided are money purchase benefits).

5. These proceedings have taken an unusual course. They began as Part 8 proceedings commenced in 2006 by Bridge Trustees Ltd ("the Trustee"), the independent corporate trustee of the Imperial Home Décor Pension Scheme ("the Scheme"). Three members of the Scheme, that is Mr John Yates (a pensioner in receipt of his pension), Mr Mark Houldsworth and Mr John Hunter (who are entitled to deferred pensions) were joined as representative defendants to represent different classes with different interests. By then the principal employer, The Imperial Home Décor Group (UK) Ltd ("the Company") was in administrative receivership and the Scheme was in course of being wound up. The claim form raised a number of questions of construction which were answered either by the deputy judge (Miss Sarah Asplin QC) or by the Court of Appeal (Mummery, Wilson and Rimer LJJ) and are not raised in this appeal. The issue which is before this Court was raised by a late amendment of the claim form which necessitated a postponement of the first-instance hearing. The appellant, the Secretary of State for Work and Pensions, was not a party to the first-instance proceedings, but regarded the decision as having serious policy implications. The Secretary of State was granted leave to intervene in an appeal (for which the deputy judge had given permission).

6. The Secretary of State agreed to pay the costs of all parties in the Court of Appeal on the indemnity basis. Before the Court of Appeal he failed to overturn the deputy judge's decision on the money purchase issue, and he now appeals to this Court on that issue as being of general public importance. It is also of great importance to the current and deferred pensioners interested under the Scheme, since if the Secretary of State is right part of the contributions paid by or in respect of members still in service or entitled to deferred pensions at the date of commencement of the winding up of the Scheme will be used, under the statutory order of priority in section 73 of PA 1995, to satisfy the rights of those already entitled to receipt of pensions at that date.

The history and structure of the Scheme

7. The Scheme was originally established as an exempt approved scheme by an interim trust deed dated 15 December 1971. It had three distinct periods in its history, summarised as follows in para 2.2 of the SFI (in which "MP benefit" means money purchase benefit within the meaning of the statute):

> "(1) From its inception to 5 April 1983 it was a conventional final salary scheme under which the members received a pension based on 1/60 of their final pensionable salary for each year of service. Members contributed 5% of pensionable salary and the employer contributed the balance of cost. No question arises as to these final salary benefits: none of them is an MP benefit.
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> (2) The Scheme was restructured with effect from 6 April 1983. It continued to provide final salary benefits, albeit on a less generous scale, the members' contribution rate being reduced to 3% of pensionable salary and the accrual rate to 1/80 per year. This was known as the Core Plan. In addition members were able to pay further contributions and thereby accrue extra benefits. This part of the Scheme was known as Voluntary Investment Planning or VIP. Again no question arises as to the Core Plan benefits, which are not MP benefits; but whether the VIP benefits are MP benefits where they take the form of internal annuities (ie where a member's pension comes into payment it is provided by the Scheme itself rather than by way of an annuity purchased for the member from an external provider, which would also have the effect of terminating the individual's membership of the Scheme) is part of the third issue on this appeal.
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> (3) The Scheme was restructured again with effect from 6 April 1992, when a further benefit structure known as MoneyMatch was introduced. Some older and longer-serving existing members (those whose age plus years of membership equalled at least 64) were given the option of continuing to accrue benefit under the existing benefit structure, namely the Core Plan and VIP. Those who were either not given the option, or chose to switch, thereafter accrued benefits on the MoneyMatch basis rather than a final salary basis, as did all new joiners. Those who switched to MoneyMatch benefits for future service could also convert their accrued final salary benefits into MoneyMatch benefits, and were given an incentive to do so. The questions whether MoneyMatch benefits are MP benefits in whole or in part are the first two issues on this appeal and (where they take the

> form of internal annuities) the other part of the third issue on this appeal."

8. In para 12 of her judgment the deputy judge summarised the effect of these changes on the members of the Scheme:

> "Therefore, after 1992 there were different categories of member:
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> (a) Option 1 members were those who had elected to convert their accrued final salary benefits into MoneyMatch and to accrue future benefits under the MoneyMatch section;
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> (b) Option 2 members were those who retained their accrued benefits in the final salary section but accrued future benefits under MoneyMatch; and
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> (c) Option 3 members were those who both retained their accrued benefits in final salary form and continued to accrue future benefits in final salary form and therefore, did not participate in MoneyMatch at all. They could accrue VIP benefits, this option being open only to those continuing to accrue final salary benefits.
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> In addition, new joiners after 22 April 1992 accrued benefits exclusively by reference to the MoneyMatch section of the Scheme."

9. On 26 June 2003 two partners in Ernst & Young LLP, Mr Garry Wilson and Mr Simon Allport, were appointed as joint administrative receivers of the Company. This triggered a statutory obligation for the appointment of an independent trustee of the Scheme, and on 18 July 2003 the Trustee was appointed to act with the previous corporate trustee, Imperial Home Décor Pension Trustees Ltd (which has since been wound up). The Company ceased to carry on business on 5 September 2003, when its remaining assets and undertaking were sold. On 22 September 2003 the Trustee resolved to continue the Scheme as a closed Scheme with effect from 5 September 2003. Having taken further legal advice the Trustee then resolved, on 15 October 2003 ("the dissolution date") that the Scheme should be wound up.

10. During the Scheme's varied existence it was governed by a succession of amending and consolidating trust deeds, including a second definitive deed dated 13 September 1984, a third definitive deed dated 21 April 1994 and (following the

Scheme's amalgamation with the Borden Wallcoverings Pension Scheme) a consolidating trust deed and rules dated 3 October 1995. These were all in evidence before the deputy judge, but it has not been suggested that they are relevant to this appeal. The last definitive deed and rules were made on 12 March 1998 in the form of a deed ("the 1998 deed") made between the Company (then named Borden Decorative Products Ltd) and the former corporate trustee (then named Borden (UK) Pension Trustees Ltd). The 1998 deed was amended in minor respects in 2000, 2002 and 2003, but again it is not suggested that any of these amendments is material to this appeal (the effect of the amendments has been noted in manuscript on the copy of the 1998 deed in evidence before us). The Scheme was contracted-out of the State Earnings Related Pension Scheme ("SERPS"), and from 2002 out of the State Second Pension, on a Guaranteed Minimum Pension ("GMP") basis.

11. As explained in para 2.2 of SFI, no question arises as to the final salary benefits earned during the first and second phases of the Scheme's history (except of course how far pensions already in payment at the dissolution date, on a final salary basis, take priority to some other benefits). The issues that arise are on VIP benefits earned during the second or third phase, and MoneyMatch benefits earned during the third phase. It is therefore necessary to describe these benefits in some detail.

VIP benefits and methods of providing annuities

12. Schedule Four to the 1998 deed contains the rules relating to the final salary benefits and (in paras 2.2, 3.2, 3.3 and 8) VIP benefits. A member could choose what VIP Contribution to pay, within various limits, and in respect of each contributing member the Company undertook to make payments called VIP Match. These started at 50% of VIP Contributions for a member with less than two years' service, rising by stages to 100% (that is, a full match) after nine years' service. The member could make a choice as to the investment of his VIP Contributions and VIP Match (together "VIP total contributions"). In practice, the choice was between investment in an account with the Yorkshire Building Society or one of two funds managed by Standard Life. At 5 April 2003 the total funds held in these two forms of investment was about £20.8m (part held as VIP total contributions, and part as MoneyMatch funds, as explained below).

13. Para 8 of Schedule Four provided for benefits in respect of VIP total contributions. This paragraph seems to have been quite extensively amended after 1998 and the manuscript notes of the amendments are far from clear. But neither side based any submissions on para 8. It is common ground that the primary benefit to which VIP total contributions were applicable was a pension, which involved the conversion (one way or another) of VIP total contributions (measured

by a sum of money) into a life annuity. Here it is necessary to make an excursus into the part that life assurance companies play in the provision of annuities for pensioners under occupational pension schemes.

14. Life offices have for many years played a very important part in this field. Mr William Phillips (one of the first members of the bar to specialise in this field) referred in his Pension Scheme Precedents, published in 1957, to home schemes (what are now called self-administered schemes) and office schemes (set up and managed by a life office). The committee chaired by Professor (now Sir) Roy Goode recorded in its influential report, Pension Law Reform (Cm 2342), published in 1993, that at that time over 97% of contracted-out money purchase schemes were insured schemes. Many of them were quite small in terms of numbers and assets, and the cost of a self-administered scheme would have been disproportionate. Counsel agreed that that 97% figure may well not hold good today, because of the general flight from final-salary schemes in recent years, which has probably increased the average size (in membership and assets) of money purchase schemes.

15. The respondents' written case distinguishes between two types of annuity provision, internal and external annuitisation. Mr Christopher Nugee QC, for the Secretary of State, told the Court that there are in fact four different types, and Mr Simmonds QC (for the deferred pensioners) accepted that refinement. The four situations are as follows.

> (1) An annuity is internally provided in the full sense if the trustees of the pension fund, having taken advice from their actuary about current annuity rates, resolve to provide an annuity at a specified rate out of the resources of the pension fund. This necessarily involves some degree of risk of the resources of the fund proving insufficient to provide all the benefits due, if investment returns are disappointing or annuitants exceed their actuarial life expectations (or both).
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> (2) The next three situations all involve obtaining annuities from life offices. The trustees may purchase an annuity from a life office and pass on instalments of the annuity, as they become due, to the pensioner. The trustees remain responsible for the annuity, but are free from any actuarial risk.
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> (3) Alternatively the trustees may arrange with the life office for the purchase of an annuity in the pensioner's own name. This is similar to situation (2) but the trustees are discharged from responsibility as soon as the annuity has been purchased.

(4) Under a scheme set up and managed by a life office the trustees of the pension scheme regularly pay premiums to the life office in respect of all the scheme liabilities, which are met by the life office. Here the annuity is paid for throughout the member's pensionable service rather than its amount depending on annuity rates current at his or her retirement.

It will be apparent that in situation (2) there are two theoretical risks: that of misappropriation or miscarriage of pension instalments, and failure of the life office. In situations (3) and (4) the failure of the life office is the only risk.

16. The way in which VIP total contributions were used in practice before the dissolution date is recorded in SFI para 2.4 (5):

> "The Trustee had power, with the member's consent, to purchase an annuity or insurance contract from an insurance company in order to secure his benefits: Schedule 2 rule 8.1. In practice however it appears that the Member's VIP Interest was converted into pension using tables of factors periodically supplied by the Scheme actuaries and (as allowed for by article 8.1.5) paid direct from the Scheme; this is what is referred to as 'internal annuitisation' and (together with the same feature in relation to MoneyMatch benefits) forms the subject matter of the third issue on this appeal."

Since the Company went into receivership, however, arrangements have been made for the purchase of annuities from a life office. Mr Giles Orton, a director of the Trustee, has deposed that in December 2004 the Trustee transferred approximately £70m to Prudential Retirement Income Ltd in respect of pensioners in order "to lock into the mortality rates and investment yields available at that time."

MoneyMatch benefits

17. The rules as to MoneyMatch benefits are set out in Schedule Three to the 1998 deed. Under rule 1 members prospectively entitled to these benefits (that is what the deputy judge called Option 1 and Option 2 members, together with new entrants after the 1992 reorganisation) paid contributions at the rate of 3% of contribution earnings. They could also opt to pay MoneyMatch Plus contributions and further supplementary contributions, within specified limits. Under rule 2 the Company made contributions (called MoneyMatch Credits and MoneyMatch Plus Credits) equal to each member's MoneyMatch and MoneyMatch Plus (but not

supplementary) contributions. There were some special transitional arrangements which it is unnecessary to go into.

18. Rule 3 dealt with the investment of total contributions. The total contributions were to be credited to a Guaranteed Interest Fund ("GIF") with the possible exception of (i) a member's MoneyMatch Plus contributions (ii) a member's supplementary contributions and (iii) the Company's MoneyMatch Plus contributions in excess of 2% of plan earnings (under the definitions in Schedule One plan earnings are defined in similar but not identical terms to contribution earnings; neither side took any point on this). These three items could be invested, at the Member's option, in the investment funds mentioned in para 12 above.

19. The GIF was defined in Schedule One as "the notional investment fund established by the Trustee for the purpose of MoneyMatch." It was notional in the sense that it was not a separate appropriated fund. It was a part, ascertainable only as a matter of accounting, of the general fund held by the Trustee for the purposes of both Core (that is, final salary) benefits and MoneyMatch benefits. The investment funds mentioned in para 12 above were separate appropriated funds, held for the purposes of MoneyMatch Plus and supplementary contributions (together with VIP total contributions as already explained). Rule 3.1.1(a) and (b) specified which contributions were to be credited to the GIF. Rule 3.1.1(c) must be set out at length as it is crucial to the appellant's case that MoneyMatch benefits were not money purchase benefits, because (it is argued) the investment return on MoneyMatch contributions is not directly related to those contributions. It provides as follows:

> "(a) At the Commencement of each Plan Year, the Trustee shall declare a rate of interest on the Guaranteed Interest Fund which shall be applicable to the Plan Year stated. The rate of interest declared shall be 1% less than the rate of interest available from the building society nominated for this purpose by the Trustee on its additional voluntary contribution accounts under company-sponsored approved arrangements for which the nominated building society is responsible for the maintenance of individual account balances. The rate of interest available is that rate at the 31 March immediately preceding the Plan Year to which the said rate is to apply.
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> (b) At each Plan Year end commencing with the Plan Year ending on 5th April 1995 the Trustee shall make (or cause to be made) a comparison of: –

> (i) the average rate of investment return on the Fund (but excluding for the purposes only of the present comparison such parts of the Fund as are attributable to the Investment Funds) applicable to the three preceding calendar years
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> (ii) the average interest rate declared for the Guaranteed Interest Fund during the last of the three calendar years in (i) above calculated as one-quarter of the interest rate that applied at the start of that calendar year and three-quarters of the interest rate that applied at the end of the calendar year.
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> (c) Where the comparison reveals a rate of return under (b)(i) above which is greater than the return under (b)(ii) above then the Trustee shall declare a bonus percentage. The bonus percentage shall be 50% of the excess of (i) over (ii) subject to such bonus not exceeding 4%."

20. Rule 4 set out the benefits to be provided in respect of a member's MoneyMatch interest on his or her retirement, early leaving, or death. Counsel did not make any submissions based on the details of these provisions, but it is worth noting that rule 4.1.3 referred to pension increases in accordance with Rule 5 in the general rules set out in Schedule Two. Rule 5.2.2 provided that "Revaluation Requirements" (defined in Schedule One by reference to the statutory code) should apply to deferred pensions in excess of GMP, and stated:

> "In particular, any money purchase benefits (as defined in section 181((1) of [PA 1995]) shall be calculated in accordance with the investment yield and any bonuses arising from the relevant payments during the period [until state pensionable age], subject to the Revaluation Requirements."

21. The general effect of the provisions in rule 3.1.1(c) is that the amount credited to a member in respect of his or her interest in the notional GIF would not necessarily, and indeed almost certainly would not in practice, precisely mirror the actual investment return on what was a mixed fund of fixed-interest government securities, equities, and cash and derivatives. Instead the member would get an annual return determined year by year by the Trustee by reference to building society rates (in the last accounting period before the dissolution date it was 3.12%) together with the prospect of a bonus equal to half the excess (if any) of the unweighted average annual investment return for the last three calendar years over the weighted average interest rate determined at the beginning and end of the year in question (but not exceeding 4%). In practice, this formula could be

expected to provide a smoother but rather lower rate of return than the actual investment return (which might in some years be negative), comparable to the smoothing effect achieved by life offices on their long-term with-profits funds.

The statutory provisions

22. The relevant definition of "money purchase benefits" is in section 181(1) of PSA 1993, applied for the purposes of section 73 of PA 1995 by section 124(5) of the latter Act:

> "'Money purchase benefits', in relation to a member of a personal or occupational pension scheme or the widow or widower of a member of such a scheme, means benefits the rate or amount of which is calculated by reference to a payment or payments made by the member or by any other person in respect of the member and which are not average salary benefits."

Leaving aside the last seven words (to which it will be necessary to return) the reader sees that the essential feature of these benefits is that their rate (typically so much a year) or amount (typically a lump sum) is to be calculated *by reference to* contributions made by the member or someone else (typically the employer) in respect of that member. A "money purchase scheme" is defined (also in section 181(1)) as "a pension scheme under which all the benefits that may be provided are money purchase benefits."

23. The issue between the parties may ultimately turn on whether the statutory words "calculated by reference to" mean (as the Court of Appeal held in *Aon Trust Corporation v KPMG* [2005] EWCA Civ 1004, [2006] 1 WLR 97, para 171) "calculated *only* by reference to, in the sense that the benefit in question must be the direct product of the contributions." The appellant contends that the need to refer to current annuity rates as well is fatal in the case of VIP benefits which may be provided by an internal annuity; and that the absence of a direct link with the actual investment return on MoneyMatch contributions is similarly fatal in the case of MoneyMatch benefits.

24. In their submissions counsel (mainly, it must be said, in response to questions from the Court) made reference to the statutory origins and contexts of the definition which the Court has to construe. PSA 1993 is a consolidating statute and in *Farrell v Alexander* [1977] AC 59 the House of Lords gave a firm warning against going behind, or beneath, the text of a consolidating statute. Lord

Wilberforce's observations on that point (at p73) are too well-known to need repetition.

25. No doubt mindful of this, Mr Simmonds, in the deferred pensioners' written case, went to the consolidating statute itself, the PSA 1993, to identify four contexts in which the definition of money purchase benefits (or that of a money purchase scheme) is relevant. He referred to the legislative history (in paras 55 to 59 of the case) only as a fallback position. The first context in PSA 1993 is the revaluation of deferred benefits. If a member changes jobs at the age of (say) 45, and does not receive a transfer payment to the new employer's pension scheme, there is a danger of the real value of the member's deferred benefits being severely eroded by inflation. Sections 83 to 86 of, and Schedule 3 to, PSA 1993 sought to remedy that problem by requiring a minimum level of revaluation of benefits. The permitted methods of revaluation are referred to in section 84(4) and are defined in Schedule 3 as the average salary method, the final salary method, the flat rate method and the money purchase method. "Flat rate benefit" is defined in section 84(4) as "any benefit the rate or amount of which is calculated by reference solely to the member's length of service". The definition of "money purchase benefits" is provided by section 181(1) as already mentioned. Schedule 3, paragraph 5(1) provides:

> "Subject to sub-paragraphs (2) and (3), the money purchase method is to apply the investment yield and any bonuses arising from payments made by or on behalf of a member towards providing any pension or other retirement benefit which is payable under the scheme to him or to any other person in respect of him in the manner in which they would have been applied if his pensionable service had not terminated."

Sub-paragraphs (2) and (3) provide for possible deductions of administrative expenses. It is the provisions of Schedule 3, para 5 that are referred to in rule 5.2.2 of Schedule Two of the 1998 deed.

26. The second context is in connection with contracting out from SERPS. This complex topic is dealt with in Part III of PSA 1993. For present purposes the most material provisions are in section 8(1), under which contracted-out employment is defined in terms of employment in a salary-related contracted out scheme or a money purchase contracted-out scheme. The statutory conditions include (section 9(3)) requirements as to "protected rights." Section 28(2)(a) contemplates that effect may be given to protected rights "by the provision by the scheme of a pension" (complying with various requirements). The appellant accepts that this covers the provision of an internal annuity (in the sense indicated in para 15(1) above).

27. The third context was provided by sections 102 to 108, under which money purchase benefits were excluded from provisions for revaluation of pensions in payment. Mr Simmonds did not develop this point, partly no doubt because the effect of sections 102 to 108 was reversed by PA 1995. But it is another context suggesting that an internal annuity is not incompatible with money purchase benefits.

28. The fourth context is the employer's statutory obligation, under section 144, to make good any deficiency of assets as against liabilities when a pension scheme is wound up, or the employer becomes insolvent (eventualities which frequently coincide). Mr Simmonds accepts that the context of this provision is unequivocally that of adequacy of funding. Money purchase schemes were excepted from the scope of section 144. Section 144 has now been repealed and replaced by section 75 of PA 1995, which also excludes money purchase schemes. This exclusion is a very important part of Mr Nugee's case for the appellant. He has submitted that it is fundamental to the scheme of the legislation (and confirmed by the EU context, referred to below) that money purchase schemes are (more or less by definition) always fully funded, with no risk of the assets being insufficient to meet the liabilities, and for that reason alone they are excepted from the funding obligation in section 75 and also from the statutory order of priority now found in section 73 of PA 1995.

Hybrid Schemes

29. As just noted, the exception in section 73 of PA 1995 applied only to money purchase schemes – that is schemes providing no benefit except money purchase benefits. But the Secretary of State had power to modify section 73 by regulations, and exercised this power by making the Occupational Pension Schemes (Winding-Up) Regulations 1996 (SI 1996/3126) ("the Winding-Up Regulations"). Regulation 13 (Hybrid schemes) provides as follows:

> "(1) In relation to any scheme-
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> > (a) which is not a money purchase scheme, but
> >
> > (b) where some of the benefits that may be provided are relevant money purchase benefits,
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> section 73 applies as if-

(i) the liabilities of the scheme did not include liabilities in respect of those benefits, and

(ii) the assets of the scheme did not include the assets by reference to which the rate or amount of those benefits is calculated.

(2) In paragraph (1) 'relevant money purchase benefits' means money purchase benefits other than-

(a) benefits derived from the payment by any member of voluntary contributions, or

(b) underpin benefits.

(3) In this regulation, 'underpin benefits' means money purchase benefits which under the provisions of the scheme will only be provided in respect of a member if their value exceeds the value of other benefits in respect of him under the scheme which are not money purchase benefits."

30. If (as has happened in this case, if Mr Simmonds is correct) both salary-related benefits and money purchase benefits are to be provided out of a single global fund of investments, it is not immediately obvious what are the "assets by reference to which the rate or amount of those benefits is calculated." The SFI states (para 4.7), without detailed reference to the facts of this particular case:

> "The effect of the statutory provisions is that if a particular benefit is classified as a relevant MP benefit, regulation 13 takes both the liability and the corresponding assets out of the mandatory priority order in section 73. If it is not a relevant MP benefit, liability for the benefit has to take its place in the section 73 order, under which priority is given to pensioners over deferreds."

But it is to be noted that under section 73(3)(a) liabilities derived from a member's voluntary contributions have the highest priority.

The EU dimension and national lifeboats

31. There are two relevant EU Directives: Council Directive 80/987/EEC of 20 October 1980 ("the Insolvency Directive") and Directive 2003/41/EC of the European Parliament and the Council of 3 June 2003 relating to the Activities and Supervision of Institutions for Occupational Retirement Provision ("IORP"). Article 8 of the Insolvency Directive provides as follows:

> "Member States shall ensure that the necessary measures are taken to protect the interests of employees and of persons having already left the employer's undertaking or business at the date of the onset of the employer's insolvency in respect of rights conferring on them immediate or prospective entitlement to old-age benefits, including survivors' benefits, under supplementary company or inter-company pension schemes outside the national statutory social security schemes."

This provision was considered and applied by the Court of Justice in *Robins v Secretary of State for Work and Pensions* (Case C-278/05) [2007] 2 CMLR 269. That case was concerned with claims by members of an insolvent salary-related pension scheme which was wound up in 2003, so that section 73 and 75 of PA 1995 applied. The Court of Justice held (paras 41 to 45) that Article 8 does not require Member States to provide a full guarantee of pension rights under private-sector schemes, but (para 59) that "a system such as that established by the UK legislation does not ensure the protection provided for by the Directive and does not constitute proper implementation of Article 8 thereof." It was for the national court (para 69 et seq) to decide, in accordance with well-settled principles, whether a remedy in damages was appropriate.

32. IORP is concerned, as its recitals indicate, with establishing "a genuine internal market for financial services". Article 15(1) and (2) provide as follows:

> "(1) The home Member State shall ensure that institutions operating occupational pension schemes establish at all times in respect of the total range of their pension schemes an adequate amount of liabilities corresponding to the financial commitments which arise out of their portfolio of existing pension contracts.
>
> (2) The home Member State shall ensure that institutions operating occupational pension schemes, where they provide cover against biometric risks and/or guarantee either an investment performance or

> a given level of benefits, establish sufficient technical provisions in respect of the total range of these schemes."

These requirements are then elaborated in paras (3) to (6). Article 16(1) provides:

> "The home Member State shall require every institution to have at all times sufficient and appropriate assets to cover the technical provisions in respect of the total range of pension schemes operated."

This requirement is then elaborated in paras (2) and (3).

33. In *Robins* the Court of Justice (paras 16 and 17) made a brief (and seemingly incomplete) reference to the statutory provisions for compensating members of insolvent schemes as they stood at that time. In this appeal the appellant Secretary of State has provided quite a full account of the far-reaching changes in compensation and funding requirements made by the Pensions Act 2004 ("PA 2004"), which radically altered the regulation of pension schemes. Part 1 of PA 2004 set up the Pensions Regulator in place of the Occupational Pensions Regulatory Authority, and Part 2 set up the Pension Protection Fund ("PPF") in place of the Pensions Compensation Board established by PA 1995 (which provided compensation only where there had been a loss caused by dishonesty).

34. PPF is funded by a statutory levy and it has the function of assuming responsibility for the pension schemes of insolvent employers in cases where the scheme is wound up after 5 April 2005. It does not therefore apply to the Scheme. Compensation is not limited to cases of dishonest mismanagement or misappropriation. But its powers do not extend to money purchase schemes (PA 2004, section 126(1)).

35. Part 6 of PA 2004 consists of a single section, section 286, which requires the Secretary of State to set up a financial assistance scheme ("FAS") for making payments to qualifying members of qualifying pension schemes. Again, money purchase schemes are excluded from the latter definition (section 286(2)). The principal regulations are the Financial Assistance Scheme Regulations 2005 (SI 2005/1986) (as amended).

36. It should also be noted that insured schemes have been comprehensively protected, throughout the whole relevant period, by the Policyholders Protection Act 1975 and regulations made under that statute.

37. Part 3 of PA 2004 (Scheme funding) is intended to strengthen the regulation of scheme funding. Like Part 2 these provisions were at least in part intended as a response to the United Kingdom's obligations under the Insolvency Directive and IORP. The minimum funding requirement regime was replaced by a new statutory funding objective (set out in section 222(1)) which is generally referred to as scheme specific funding ("SSF"). These provisions do not apply to money purchase schemes (section 221(1)).

38. The appellant's printed case places some emphasis on the fact that money purchase schemes are excluded from the PPF regime, the FAS regime and the SSF regime. With the exception mentioned below, the parties' written and oral submissions did not explain how those regimes apply to schemes which provide some money purchase benefits without being exclusively money purchase schemes. The exclusion of money purchase schemes is not, I think, directly relevant to the issues that the Court has to decide, but was mentioned as part of a general submission (which is, as already noted, an important part of Mr Nugee's case) that money purchase schemes are by their nature always fully funded, and free from any risk of actuarial insolvency. It is also part of a more particular submission on the *Marleasing* principle (*Marleasing SA v La Comercial International de Alminentación SA* (Case C-106/89) [1990] ECR I-4135) that this Court should prefer a construction which avoids infringement, or possible infringement, of EU obligations. This point was not raised before the deputy judge (when the Secretary of State was not an intervener). It was raised and rejected by the Court of Appeal (paras 95 and 96).

39. The exception mentioned above is that the diligence of Mr Nugee and his junior, Mr Hilliard, produced on the second day of the hearing a "note on the treatment of deferred scheme members" setting out the appellant's counsel's view on the practical outcome of the competing cases on the first issue, in terms of what different classes of pensioners would receive from the combined resources of the Scheme and FAS. The rules of FAS as they apply to the Scheme do not at present cover all money purchase benefits that fall to be dealt with under section 73 of PA 1995 (though there is a consultation in progress about this). Although this note was produced in response to a request from the Court I think it better not to refer to it. This is partly because the note was not (I think) agreed by Mr Simmonds. But the more important reason is that this Court has to decide the issues of construction as a matter of principle, and without regard to the practical consequences, however much sympathy we may feel for all the pensioners, faced as they are with a long delay in the final determination of how the Scheme's inadequate funds should be divided.

The KPMG case: at first instance

40. The decision of the Court of Appeal in *Aon Trust Corpn v KPMG* [2006] 1 WLR 97 ("*KPMG*") is the only decision of that court which has any close bearing on the issues in this appeal. It has therefore received close attention at every stage in this litigation. The deputy judge, who was of course bound by the decision, distinguished it (primarily at paras 129 to 134 of her judgment). The Court of Appeal, which was also bound by the decision, also distinguished it, primarily at paras 143 to 145 (as regards MoneyMatch benefits) and paras 150 to 152 (as regards internal annuitisation).

41. Mr Nugee's position is that *KPMG* was rightly decided and that in this case the Court of Appeal was in error in distinguishing it. Mr Simmonds accepts that it may have been correctly decided on its facts, but criticises some important parts of its reasoning. On any view it is necessary to take a close look both at the first-instance decision of Sir Andrew Morritt V-C (who is very experienced in the pensions field) [2004] EWHC 1844 (Ch) [2005] 1 WLR 995, and at the judgment of the Court of Appeal (delivered by Jonathan Parker LJ, with whom Mummery and Chadwick LJJ agreed).

42. The case related to a pension scheme which started life in 1949 as the staff pension scheme of Peat Marwick Mitchell & Co. Until 1999 periodic actuarial valuations showed that the scheme was in surplus, but in that year a small deficit was disclosed. In consequence the scheme was amended to split the pension fund into two, with effect from 31 March 2000. There was a pre-2000 fund which became a closed fund (that is, no new entrants were permitted) and a post-2000 fund which was described by the Vice-Chancellor, in para 2, as "a conventional money purchase scheme." The proceedings related to the pre-2000 fund ("the closed fund"). The principal issue in the Court of Appeal was whether the closed fund also was held in a money purchase scheme for the purposes of PSA 1993 and PA 1995 (it was common ground that if it was, the scheme was a relatively unusual type of money purchase scheme). This issue arose in Part 8 proceedings in which the corporate trustee ("Aon") sought directions on several matters, including whether the employer, KPMG, was liable or potentially liable under PA 1995 to make good a deficit in the closed fund which had grown, by the time of the 2002 triennial actuarial valuation, to about £71m.

43. The scheme affecting the closed fund was unusual in that it combined one of the salient features of a money purchase scheme – defined contributions of equal amount made by both member and employer in respect of that member's prospective benefits – with actuarially determined formulae under which the amount of pension earned by any member was provisionally ascertainable year by

year during a member's service. This process was however provisional only because clauses 8.4 and 8.5 of the trust deed provided as follows:

> "8.4. If an actuarial valuation or interim review of the pre-2000 fund shows a surplus the trustees may with the consent of the principal employer and after taking the actuary's advice and after making any such amendments to the trust deed and/or rules as may be necessary, decrease the contributions of any member and/or increase (by declaration of bonuses or interim bonuses or otherwise) the benefits or future benefits of any member or other person entitled to receive any benefit from the pre-2000 fund.
>
> 8.5. If an actuarial valuation of the pre-2000 fund reveals a deficiency in the pre-2000 fund's resources the trustees may with the consent of the principal employer make such adjustments and amendments to the benefits secured or thereafter accruing for and in respect of the members as are necessary in the opinion of the trustees after taking the actuary's advice to secure the continued solvency of the pre-2000 fund."

44. It will be observed that these provisions are not strictly mandatory. They confer fiduciary powers, to the exercise of which KPMG had to consent. The alteration in contributions or benefits under clause 8.4 did not have to be carried out in any particular way (though no doubt a general duty of fairness was implicit), and clause 8.5 was similarly unspecific as to how continued solvency was to be maintained. Moreover (by clause 8.2 and 8.3) only the statutory triennial valuation was mandatory, and it was for the trustees to decide (with KPMG's consent) whether to obtain more frequent actuarial valuations or interim actuarial reviews. The operations of the provisions of clause 8.4 and 8.5 ("the clause 8 powers") was therefore by no means automatic or rigidly linked to changes in investment returns (as opposed to life expectancy).

45. In para 14 of his judgment the Vice-Chancellor gave what he called a simplified example:

> ". . . take a male aged 25 at his next birthday in the calendar year 1999. The factor is 0.960 for a pension payable unreduced at age 65. If in that year he earned £20,000 and the contribution rate for both him and the employer was 4% then the computation of benefit on retirement at age 65 would be £20,000 x 8% (ie £1,600) x 0.960 = £1,536 per annum. If in the same year there had been a bonus declaration of 5% under clause 8.4 then the pension in respect of that

> year of service would have increased to £1,612.80 (£1,536 + (5% x £1,536)). On the other hand a deduction of the like percentage under clause 8.5 would give rise to a pension aged 65 of only £1,459.20. The formula is applied for each year of service to the contributions made in that year and the pension at retirement is the sum of the product of such computations for each year of service."

46. The last sentence of this passage may be describing how the clause 8 powers were exercised in practice. I rather doubt whether that was the only permissible way of exercising the powers. But the general pattern was what was described in argument as building blocks: each year's contributions produced a provisional component of the eventual pension, but the cumulative process could be either accelerated or retarded, at least once every three years, by the exercise of the clause 8 powers.

47. The context in which the *KPMG* proceedings were brought was that the closed fund had an uncomfortably large deficit and the trustee, Aon, was no doubt considering a fairly drastic exercise of its clause 8.5 power. Three issues were raised at first instance: (i) whether the power could be used to reduce pensions already in payment; (ii) whether the power was a power of modification within the meaning of section 67 of PA 1995 (and so subject to statutory restrictions); and (iii) whether the scheme was a money purchase scheme, so that KPMG was not subject to statutory obligations to make payments under sections 60 and 75 of PA 1995. The Vice-Chancellor answered questions (i) and (ii) in the affirmative (paras 18 to 33) and question (iii) in the negative (paras 34 to 58).

48. The Vice-Chancellor reached his conclusion on the third question on two alternative grounds, one particular and one general. The particular ground was the exclusion of "average salary benefits" from the statutory definition of money purchase benefits. The Vice-Chancellor explained (paras 52 to 55) that average salary benefits, whatever particular mechanism is used to compute them, are likely to have elements of both defined contribution and defined benefit, and that the last seven words of the statutory definition are in the nature of a tie-break (para 55):

> "An average earnings-related scheme is likely to have resort to both earnings and contributions/payments in the ascertainment or definition of the benefit. It is necessary to do so in order to take account of both the level of earnings going to make up the average and the time when they arose. This, in my view, is the explanation for the exclusion of average salary benefits at the conclusion of the definition of 'money purchase benefit'."

That explanation is illuminating but not directly relevant to this appeal.

49. The more general ground of decision is undoubtedly relevant. The Vice-Chancellor reviewed the contexts in which money purchase benefits and money purchase schemes appear in PSA 1993 and PA 1995 (most of these are noted at paras 25 to 28 above). He drew from them two general conclusions. One is in para 46:

> "Nevertheless it appears to me to be obvious that Parliament recognised that in a money purchase scheme in all normal circumstances the benefits are matched by equivalent assets. This is to be contrasted with a defined benefit scheme, such as a final salary scheme, when assets and liabilities will not match each other unless the actuarial and other assumptions on which the level of contribution was fixed actually occur."

The other general conclusion is set out, in very similar terms, in paras 42, 44 and 47; I quote from para 44:

> "Thus the distinction recognised that a money purchase benefit had no guaranteed or defined benefit for it depended on the investment yield obtained or attributable to the fund derived actually or notionally from the contributions made by the member and his employer."

50. In each of the three formulations the Vice-Chancellor used the expression "investment yield". I think it is clear that he was referring not simply to income yield, but to what is generally referred to in the financial services industry as "investment return" or "total return" – that is income yield together with capital appreciation (if positive during the relevant period) or the difference between the two (if there is a fall in capital value during the relevant period).

51. The Vice-Chancellor also accepted KPMG's submission (para 54) that the statutory definition must be applied "with regard to the substance of the calculation." He saw that approach as leading both to what I have called the particular ground of decision (para 56) and the more general ground (para 57), on which he considered that the "contingent and discretionary" effect on benefits of the clause 8 powers was inconsistent with their being money purchase benefits.

The KPMG case: Court of Appeal

52. All three issues were raised on the appeal, and on the issue of the reduction of pensions in course of payment the appeal was allowed. Very clear words would have been needed to authorise such a step, and the clause 8.5 power did not go that far. The appeal as to whether the clause 8 powers came within section 67 of PA 1995 was dismissed. We are concerned mainly with a decision on the money purchase issue, on which the Court of Appeal reached the same conclusion as the Vice-Chancellor, but for reasons that were expressed in rather different terms.

53. In discussing money purchase schemes in general, Jonathan Parker LJ observed (paras 31 and 32):

> "Alternatively, an employer setting up an occupational pension scheme may decide to define the level of benefits by reference solely to the contributions made in respect of the member concerned, so that the benefit represents no more and no less than the product of the contributions. Such a scheme is commonly called a 'money purchase scheme' (I will come to the statutory definition of that term later).
>
> Thus in a typical money purchase scheme there can, by definition, be no mismatch between assets and liabilities. Hence there is no need (indeed, no scope) for a 'balance of cost' obligation on the employer, since the level of contribution dictates the level of benefit and no 'balance of cost' can arise."

54. Counsel's arguments before the Court of Appeal were recorded at some length, the parts relevant to the money purchase issue being paras 106 to 117 (Mr Sumption QC for KPMG), paras 123 to 134 (Mr Green QC for the representative active member) and para 148 (Mr Ham QC largely adopting Mr Green's submissions). I will not try to analyse these in detail. There was a good deal of argument about the nature and significance of the clause 8 powers. The argument for KPMG was that they were an integral part of the process of calculating benefits by reference to contributions, and not a provision for reducing settled entitlements. Against this the members stressed what the Vice-Chancellor had called the "contingent and discretionary" nature of these powers. In this appeal the nature and effect of the clause 8 powers have to be compared with the nature and effect of the provisions in rule 3.1.1(c) of Schedule Three of the 1998 deed.

55. Jonathan Parker LJ discussed the rival arguments and set out his conclusions on this issue at paras 151 to 176. In summary (which cannot do justice to the detailed development of his reasoning) the steps were on the following lines.

(1) The key to the problem is "in the relationship between contributions and benefits, as that relationship emerges from a consideration of the scheme as a whole, properly construed" (para 151).

(2) The clause 8 powers were not automatic, but discretionary, in their operation (para 153).

(3) The calculation of benefits was a three-stage process, with the clause 8 powers as a distinct stage, involving actuarial factors, which were also involved in the formulae at the first stage (paras 155 to 166).

(4) The scheme lacked the basic characteristics of a money purchase scheme: "In the first place, the requisite direct relationship between contributions and benefits is broken by the introduction of actuarial factors. As Mr Ham succinctly put it at the conclusion of his submissions, in the case of a money purchase scheme you do not need an actuary. Secondly, by including the [clause 8 powers] the scheme not only recognises but positively caters for a continuing mismatch between assets and liabilities" (para 167, some references omitted).

(5) The inclusion at the first stage of actuarial factors made it impossible for the scheme to qualify as a money purchase scheme: "the expression 'calculated by reference to' means, in my judgment, 'calculated *only* by reference to', in the sense that the benefit in question must be the direct product of the contributions" (para 171).

(6) The Lord Justice also agreed with the Vice-Chancellor's alternative ground of decision, the exception for average salary benefit, while commenting that the true reason for it would have to remain a mystery (para 174).

The judgments below

56. The deputy judge had to decide several issues. On the money purchase issue she distinguished *KPMG* as a "building block" scheme in which actuarial factors

were an integral part of the calculation process. She said in relation to the GIF mechanism (para 137):

> "Despite the fact that the final rate of return to be applied to the Member's Interest is arrived at by the addition of a bonus percentage to the initial conservatively declared rate, in my judgment, it is merely a rate of return nevertheless. The mechanism by which the rate is arrived at is just that."

She considered that to distinguish between the internal and external provision of annuities would produce anomalies. The Court of Appeal rightly paid generous tribute to her judgment.

57. The judgment of the Court of Appeal (delivered by Mummery LJ, but recording that all members of the Court had contributed to it) is, if I may respectfully say so, an admirable effort in explaining a very complex topic in language comprehensible to the members of the Scheme. But the judgment acknowledged the difficulties (paras 38 and 39):

> "The Court's aim has been to produce, as far as possible, a judgment that Scheme members can themselves understand, if not the dense detail, at least the crucial conclusions and the reasons for them. This is particularly important in a case where the benefits of the members are significantly scaled back . . .
>
> Attempts to translate the legislation and the Scheme precisely into ordinary English for the benefit of a wider audience of non-experts are probably doomed to failure. The complexity of the subject must be respected. Over-simplification that does not do so could make matters even worse by causing confusion and misunderstanding through error and inaccuracy."

58. The Court of Appeal identified seven issues as arising in the appeal. All but one of them were concerned with different aspects of the definition of money purchase benefits and money purchase schemes. The exception concerned the meaning of "voluntary contributions" in section 73(3)(a) of PA 1995, which is no longer in issue. The issues before the Supreme Court are the first two money purchase issues, designated and discussed in the judgment of the Court of Appeal as follows:

> (1) Are MoneyMatch benefits money purchase benefits despite the presence of the GIF? (paras 139 to 145)
>
> (2) Are pensions granted by way of internal annuities money purchase benefits? (paras 146 to 152).

So although the judgment runs to 189 paragraphs the Court's discussion of the crucial issues, and its conclusions on them, can be found in fourteen closely-reasoned paragraphs. This economy of expression was achieved partly because the judgment had already (paras 54 to 98) considered the *KPMG* case at length.

59. The discussion of *KPMG* contains some very pertinent observations (paras 57 to 59) about the role of precedent in statutory construction. As the report is readily available it is unnecessary to repeat them. Their general tenor (with which I whole-heartedly agree) is that judgments on statutory construction are not to be read as if they were themselves statutes, and that apparently wide propositions may have to be read in the context of the particular facts of the case to which they related.

60. The Court of Appeal drew four conclusions (paras 85 to 90) as to the significance of *KPMG* for the present appeal. First, the scheme in that case was essentially a defined benefit scheme, although that feature was embodied (or concealed) in the actuarial formulae which provided the "building blocks" of the eventual pension. Second, *KPMG* contained no teaching about internal annuities or the presence of guaranteed notional returns provided by the GIF. Third, the relationship between contributions and benefits must be determined by looking at the scheme as a whole; the impossibility of a mismatch between assets and liabilities was not a necessary condition of a money purchase scheme, although it was a feature of a typical money purchase scheme.

61. I will set out the fourth point in the Court's own words (para 90):

> "… we are also unable to accept that a benefit is precluded from being an MP benefit simply because an actuarial factor is applied at *any* stage of the calculation, or because the MP benefit pot is increased by reference to a guaranteed or notional return, as with a guaranteed interest fund. There is force in the comment that there would be no MP benefits at all if the introduction of an annuity rate to convert the capital value of the member's MP pot into a pension income for the member prevented that benefit from qualifying as an MP benefit. In every case an annuity rate has to be applied, either by

> an insurance company in the case of the external provision of an annuity, or by the Trustee in the case of internal annuitisation. The important point in such cases is that the pension benefit is related to the size of the member's interest or account in the relevant Scheme fund."

62. The Court of Appeal concluded that the approach taken by counsel for the Secretary of State and the pensioner was over-analytical and too literal in its treatment of *KPMG.* It considered (para 92):

> "The question in each case is to ask whether, having regard to the combination of all the features of the scheme in question, the rate or amount of the benefit in question can be sensibly and reasonably said to be calculated by reference to the payments by or in respect of the members. That could not be said in the case of *KPMG*. As explained below, it can be said here in relation to the calculation of the Member's Interest and the VIP Interest, notwithstanding the particular features on which the Department and the pensioner rely for their objections to the members' benefits being MP benefits."

The Court did not accept that the *Marleasing* principle was of any assistance in construing the statutory definition (paras 95 and 96).

63. Following that approach, the Court of Appeal thought it wrong to read into the statutory definition a requirement that money purchase benefits (para 144):

> ". . . must be the 'direct' and 'actual' products of the payments in order to be MP benefits. Those words are not in the definition. It is true that they were used in *KPMG*, but that was in the context of a very different scheme. In that case the liabilities to members turned on the application of tabulated multipliers to contributions. That calculation was a break in the link between the benefits and returns on invested contribution payments to that scheme."

By contrast the use (in the GIF mechanism) of notional returns on the invested contributions did not break the link. The benefits were still calculated "by reference to" contributions (para 145).

64. As to internal annuitisation, the Court recognised that it brought actuarial factors into play. But (para 152) this was only at the final stage of converting a

sum of money into a retirement annuity. The benefits were still calculated by reference to the total contributions.

Discussion: some preliminary points

65. This Court has had the benefit of excellent written and oral submissions from counsel. It is unnecessary to summarise them at length. Mr Nugee has placed particular emphasis on the *promise* of future benefits as the hallmark of defined benefit schemes; on the equilibrium of assets and liabilities as the hallmark of money purchase schemes, and the reason why they are largely excepted from the operation of sections 73 and 75 of PA 1995; on the Court of Appeal's insistence, in *KPMG*, that a money purchase member's benefit should be "the direct product of the contributions"; and on *Marleasing*. Above all, Mr Nugee appealed for clarification and certainty in the law.

66. Mr Simmonds submitted that Mr Nugee had started with a gloss on *KPMG* and worked backwards from that. He explored the four statutory contexts dealing with money purchase benefits (these are covered in paras 25 to 28 above). He relied on some particular linguistic points on the legislation (including the use of "solely" in the definition of flat rate benefit in section 84(4) of PSA 1993, and the exclusion from the definition of money purchase benefits of average salary benefits). He suggested that in considering the meaning of the words "calculated by reference to" it was helpful to look at the variables and the constants employed in calculations under different types of scheme.

67. It may be best to start by dealing with three points which can to my mind be disposed of fairly quickly. First, *KPMG* was rightly decided. The use of the actuarial formulae and the width of the clause 8 powers (and the uncertainty as to those powers being exercised either at all, or in any particular way) produced what was on any view too wide a discontinuity between the quantum of a member's total contributions (and the return on them), on the one hand, and the benefits to which the member would eventually become entitled, on the other hand. This conclusion is amply confirmed by (rather than being a consequence of) the deficit of over £70m which had appeared in the closed fund by 2002.

68. Secondly, however, some of the reasoning in the Court of Appeal's decision in *KPMG* (and in particular, para 171, quoted in para 55(5) above) is open to question: this is considered further below. I consider that the Vice-Chancellor was correct in what he said (para 48 above) about the exception from the statutory definition of average salary benefits.

69. Thirdly, the *Marleasing* principle is of no real assistance here. In relation to the United Kingdom's obligations under article 8 of the Insolvency Directive, *Robins v Secretary of State for Work and Pensions* (Case C-278/05) [2007] 2 CMLR 269 shows a very broad-brush approach, with the outcome determined largely by the statistics quoted in paras 58 and 61 of the judgment of the Court of Justice. Since the vast majority of money purchase schemes are insured schemes, and since it is agreed that most self-administered money purchase schemes have no risk of insolvency, it is hardly conceivable that any drafting error in the legislation could amount to a grave and manifest breach of Community law. Similarly with IORP; if there is an error in the changes made by Part 3 of PA 2004, it is for Parliament to correct it. For the Court to attempt correction by stretching or distorting the statutory language would be likely to lead to more anomalies and more confusion.

"Calculated by reference to . . . payments"

70. In the discussion of whether the critical words of the definition should be construed strictly (Jonathan Parker LJ's approach, [2006] 1 WLR 97, para 172) or in terms of what can sensibly and reasonably be regarded as within the words (Mummery LJ's approach, para 92) little attention has been paid to the question of the inclusion within the definition of the investment return (in the sense indicated in para 50 above) on a member's total contributions. The only relevant statutory reference that I have found is in the context of revaluation of deferred benefits, where there is a reference to "the investment yield and any bonuses arising from payments" (PSA 1993, Schedule 3, para 5(1), set out in para 25 above). Section 87 of PA 1995 and regulations made under it require pension scheme trustees or managers to keep detailed records of contributions to money purchase schemes, but those requirements do not appear to cover the investment return on the contributions.

71. No one suggests that the investment return on contributions is not properly included in the calculation of money purchase benefits. In *KPMG* the Vice-Chancellor emphasised that they were included (see paras 49 and 50 above). Indeed, the statement in the House of Commons in 1986 by Mr John Major MP (quoted by Jonathan Parker LJ in para 112 of his judgment [2006] 1 WLR 97) suggests that the inclusion of investment return is of the essence of money purchase benefits. The fact is, however, that the statutory definition in section 181(1) of PSA 1993 makes no reference to investment return. Still less is there anything in the statutory definition requiring meticulous investigation as to the actual investment return earned over the years by every contribution made in respect of a member. A scheme which provided for a "pot" (to my mind an unhelpful term, since it suggests an appropriated mini-fund) of a member's total contributions together with annual interest thereon at (say) 3% compounded annually would be just as much "calculated by reference to . . . payments" as one

which took account of the exact investment return on investments actually or notionally representing the payments. Arguably it would fit better with the statutory definition. It is also worth noting that a scheme which provided for annual interest at the rate of (say) 8% per annum compounded annually would be likely, in the first decade of this century, to have encountered grave solvency problems, although it would seem to fall squarely within the statutory definition.

72. I do therefore respectfully differ from the key conclusion reached by Jonathan Parker LJ in para 171 of his judgment in *KPMG* [2006] 1 WLR 97, that "'calculated by reference to' means . . . 'calculated *only* by reference to', in the sense that the benefit in question must be the direct product of the contributions." This interpretation involves reading in the word "only", which Parliament did not use (whereas it did use "solely" in the definition of "flat rate benefit" set out in para 25 above). The altered phrase is then explained ("in the sense that") by reference to the contributions' "direct product" though the statutory definition makes no express reference to investment return.

73. It follows that the deputy judge (see para 56 above) and the Court of Appeal (see para 63 above) were right, in my judgment, to conclude that the GIF mechanism did not unhitch a member's eventual benefits from that member's total contributions. They provided for a yield of guaranteed interest at a modest rate fixed by an objective test, together with the prospect of further bonuses at a modest rate, fixed, again, by an objective test under which the trustees had no discretion. All that is in striking contrast to the much looser terms of the clause 8 powers in *KPMG*.

74. In the Court of Appeal in *KPMG* [2006] 1 WLR 97, Jonathan Parker LJ was impressed by the submission of counsel for the representative pensioner (para 148) that with a money purchase scheme there is no need for an actuary. That proposition is entirely correct in the sense that under Regulation 3(2) of the Occupational Pension Schemes (Scheme Administration) Regulations 1996 (SI 1996/1715), it is not obligatory to appoint a scheme actuary for a money purchase scheme. That provision (to which we were not, I think, referred) is consistent with the view that under a money purchase scheme (if not by definition) there should be no mismatch of payments and liabilities. But a statutory instrument made in 1996 cannot affect the construction of a definition in PSA 1993. Moreover, as I have just illustrated, the choice of an over-optimistic fixed rate of return can lead to solvency problems, as Equitable Life discovered in another context (see *Equitable Life Assurance Society v Hyman* [2002] 1 AC 408).

75. There is no evidence before the Supreme Court that the Scheme's deficit is the result of the GIF mechanism. It seems more likely that it has arisen in respect of the final salary part of the Scheme, but the actuarial reports exhibited to Mr

Orton's affidavit are not before the Court (with the exception of a report dated 20 March 2008 which is not, without explanation, of much assistance). This point may be relevant in connection with Regulation 13 of the Winding-Up Regulations, discussed further below.

Internal annuities

76. In my judgment the deputy judge and the Court of Appeal were also correct in their conclusion that the provision of internal annuities (as opposed to the purchase of annuities from a life office) is not incompatible with money purchase benefits. As the deputy judge put it (para 135) the distinction would produce insupportable anomalies. As the Court of Appeal put it (para 152), annuity tables based on actuarial calculations are used only at the final stage, when the member retires and the amount earned by his or her defined contributions must be converted from a lump sum into an annuity. That is inescapable under either method of provision, in that actuarial tables will be used, on the advice of actuaries, either by the trustees or by the life office (with the latter building in a profit element).

Regulation 13

77. The Court did not hear full submissions as to the effect of Regulation 13 of the Winding-Up Regulations, but (as already noted in para 30) the reference in Regulation 13(1)(ii) to "the assets by reference to which the rate or amount of those benefits is calculated" is not easy to apply when the money purchase benefits are to be provided out of a single unappropriated fund which is insufficient to meet all its liabilities for defined benefits and money purchase benefits.

78. This point is not expressly raised in the SFI, but it would be most unfortunate if it had to be referred back to a judge of the Chancery Division, with further costs and further delay. In these circumstances I think it right to say that in my view Regulation 13(1) must be interpreted on the basis that Parliament contemplated (as all sides agree) that money purchase benefits would normally be adequately funded but not over-funded, and that the money or assets to be withdrawn from the unappropriated fund for the purposes of section 73 of PA 1995 should be of an amount or value equal to the money purchase benefits calculated by the GIF mechanism (less members' MoneyMatch Plus contributions, employers' MoneyMatch Plus credits in excess of 2% of Plan earnings and supplementary contributions which under Regulation 13(2)(a) are not "relevant money purchase benefits", but take first priority under section 73). However if counsel for any party feels that this point has been insufficiently argued the Court would entertain further brief written submissions limited to this single point.

Conclusion

79. In his submissions for the Secretary of State, Mr Nugee (invoking, as it were, the prayer of Ajax: *St Aubyn v Attorney General* [1952] AC 15, 45) pleaded for clarity above all, even if he were to be unsuccessful in his arguments. I have considerable sympathy with that, and so will many others who have to grapple with the complexities of the primary and secondary legislation relating to occupational pension schemes. It is a striking fact that the Trustee's report for the year to 5 April 2003 (signed off by the new independent trustee after the dissolution date, and no doubt very carefully considered by the Trustee's directors, the auditors and the actuary) stated as a fact that the Scheme had a defined contribution section. None of these experienced professionals expressed any doubt about the point until the Secretary of State's intervention.

80. That is not to say that the Secretary of State's intervention was unnecessary. Although this Court holds that equilibrium of assets and liabilities is not a requirement of the statutory definition of a money purchase scheme (and similarly for money purchase benefits), it is clear the Parliament has enacted primary legislation, and the Secretary of State has initiated secondary legislation, on that assumption. Nevertheless in all insured schemes, and in the great majority of self-administered schemes, that assumption is in practice justified. To the special cases on which counsel agreed (insolvency of a life office, or misappropriation of trust funds) there may have to be added the case of an over-optimistic guaranteed fixed rate of return on contributions, or the eventuality of unexpectedly high administration costs (the costs of all parties to litigation such as this are normally paid out of the trust fund, especially if the employer is insolvent, and can be a significant burden for a small scheme). The possibility of exceptional cases of that sort seems unlikely to amount to an infringement of Community obligations, or to necessitate primary legislation as a matter of urgency (although Regulation 13 of the winding-up regulations may need clarification). But those are matters for the Secretary of State and for Parliament.

81. For these reasons I would dismiss the Secretary of State's appeal on the first and third issues. The second issue (apportionment of MoneyMatch benefits) does not arise.

LORD MANCE

82. I have found the resolution of this appeal more difficult than the majority. As Lord Walker points out, the Pensions Schemes Act 1993 ("PSA 1993") is a consolidating statute, and we should look at it, rather than undertake historical

archaeology. The critical question is what is comprised within the concept of "benefits the rate or amount of which is calculated by reference to a payment or payments made by the member or any other person in respect of the member and which are not average salary benefits" (PSA 1993, s.181(1)).

83. Although the legislative history is not relevant, the factual background at the time of PSA 1993 may be. While it was only by the Pensions Act 1995 ("PA 1995") (amending PSA 1993 and other prior legislation and introducing various new provisions) that Parliament addressed issues raised by the Report of the Pension Law Review Committee chaired by Professor Roy Goode issued in January 1993, that Report must reflect the general understanding of the nature of a money purchase scheme at the time when PSA 1993 was passed. The Report proceeds on the basis (see e.g. paras 2.2.20, 2.4.24 and 4.4.3) that, since under a money purchase scheme the scheme member bears the investment risk, there cannot "in principle" be a deficiency of assets, save in the case of loss of assets through fraud or misappropriation.

84. The Report also confirms (App 4 Table 10, and see paras 2.4.20 to 2.4.31) that in 1993 most money purchase schemes were insured, and in particular (para 2.3.29) that over 97% of the 26,500 such schemes then contracted out (under what became Part III of PSA 1993) were insured. It is true that insurers can in theory become insolvent, in which case a scheme which had insured itself in respect of a money purchase benefit could suffer a shortfall, but in practice insurance industry solvency is tightly regulated, and there is also extensive statutory protection for beneficiaries in any insolvency.

85. In the present case, the risk of underfunding due to the promised VIP and MoneyMatch benefits may or may not have been slight. But, if benefits of this kind do not undermine the essential nature of the scheme as a money purchase scheme, I find it difficult to see where the line is drawn. This is to my mind confirmed by what I understand to be Lord Walker's view in para 71 that a provision for annual interest on a members' total contributions compounded at say 3% or even 8% per annum would still remain a money purchase benefit.

86. It is true that s.181(1) does not itself expressly delimit what is meant by "benefits the rate or amount of which is calculated by reference to a payment or payments". But the reason appears to me likely to have been that a direct relationship was implicit. I regard s.84, providing for the revaluation of deferred pensions (accrued at early retirement) to be made "using the money purchase method" described in Schedule 3, para 5, as pointing strongly in the same direction. Para 5 states that, with presently immaterial qualifications, "the money purchase method is to apply the investment yield and any bonuses arising from payments made by or on behalf of a member towards providing any pension or

other retirement benefit which is payable under the scheme to him or to any other person in respect of him in the manner in which they would have been applied if his pensionable service had not been terminated". The inference is that money purchase benefits are linked directly to an investment yield and/or (e.g. under with profits policies) to bonuses actually declared.

87. A similar inference appears to me to arise from s.144 (which later became s.75(1) of PA 1995), whereby it is only "in the case of an occupational pension scheme which is not a money purchase scheme" that an employer is bound to make good to the scheme trustees an amount equal to an excess of the schemes' liabilities over the value of its assets. It cannot therefore have been contemplated that there could be any real risk of liabilities exceeding assets in the case of a money purchase scheme. Under s.153(1) of PSA 1993 (s.89(2) of PA 1995) the Secretary of State was given power by regulations to make similar provision, subject to such modifications as he might specify, in respect of other cases. Section 125(2) of PA 1995 conferred a like power expressly in relation to schemes which are not money purchase schemes, but where some of the benefits that may be provided are money purchase benefits. In the event, however, and consistently with the Goode Report (para 83 above), the only possibility addressed by regulations was that of criminal reduction in the aggregate value of the allocated assets of any money purchase scheme: see regulation 7 of the Occupational Pension Schemes (Deficiency on Winding-Up etc) Regulations 1996 (S.I. 1996 No. 3128) requiring the employer to make good any such loss. Again, this confirms that it was contemplated in 1993 (or one might add subsequently) that there could not be any other real risk of shortfall in respect of a money purchase scheme.

88. Mr Simmonds QC in his excellent submissions for the scheme member respondents relied upon two other sets of provisions in PSA 1993: the first consists of s.10(1) read with s.28, according to which, in the context of contracting out, protected rights to money purchase benefits may be given effect "by the provision by the scheme of a pension which" complies with or satisfies certain requirements or conditions; and the second consists of ss.102-108, which require the provision by schemes of annual increases by reference to the RPI of "any pension which commences or has commenced under the scheme, but does not include - (a) a guaranteed minimum pension or any increase in such a pension under section 109; or (b) any money purchase benefit" (section 102(3)). Both sets of provisions therefore contemplate that a money purchase benefit may be given effect by a pension granted by the scheme itself. However, as Mr Nugee QC in his equally excellent submissions pointed out, any pension would in practice have been achieved in 1993 by the means of a back-to-back insurance taken out by the scheme, either when the member entered the scheme or when he or she retired and sought an annuity. It would not have been achieved by an internal pension exposing the scheme alone. On that basis, these sections do not contemplate, even

on retirement, a situation in which the scheme would or could be exposed to any mismatch of liabilities and assets. If and in the event that a pension was granted without matched asset backing in the form of an insurance, the appropriate analysis would be that the benefits conferred by the scheme had become defined benefits, rather then money purchase benefits.

89. Weight was placed by Mr Simmonds on the presence at the end of the definition in s.181(1) of PSA 1993 of the words "and which are not average salary benefits". A definition of "average salary benefits" appears in s.84, albeit in terms only for the purpose of that section, where it means "benefit the rate or amount of which is calculated by reference to the average salary of a member over the period of service on which the benefit is based". The words "and which are not average salary benefits" must have been meant to make clear the need for an investment link which is, on any view, the key to a money purchase scheme or benefit. It does not follow that they were necessary, still less that the link can be partial rather than complete. There are other instances in the legislation where opposites are expressly excluded, e.g. in ss.73 and 125(1) of PA 1995, where a salary related scheme is expressly defined as a scheme which is not a money purchase scheme. I cannot attach significant weight to an addition to s.181(1) which can be read as simply making the antithesis clear.

90. Lord Walker notes (para 79) that the present trustees presented the MoneyMatch section of their scheme as "a defined contribution section" in the scheme accounts for the year ended 5 April 2003, as they continue to do to this day. But to my mind a more telling indication of professional understanding is provided by the Actuarial Guidance Note GN27 issued by the Faculty & Institute of Actuaries, paragraphs 3.3 and 3.4 of which have been in the same form since version 1.5 effective from 1 December 2000 (and in almost identical form from the outset in version 1 effective from 6 April 1997). They read:

> "3.3 The value of the liabilities must not be limited to the value of the assets, even where the scheme rules may so provide. In particular, in the valuation of the liabilities in hybrid schemes which give a money purchase benefit subject to a defined benefit promise, the value of the defined benefit promise must not be limited to the value of the assets of the scheme, even if the rules of the scheme restrict the benefit promise where there are not sufficient assets in the scheme.
> 3.4 The liability in relation to money purchase benefits will, where contributions are accumulated, either in identifiable assets or otherwise, be the accumulated value at the MFR Effective Date, and, where contributions are used to provide minimum benefit rights payable as at a future date, be the value of those rights using the relevant assumptions specified in Appendix 2. Money purchase

> benefits which have been converted into defined pension rights on the retirement of the member must be valued in the same way as other benefits for pensioners."

These paragraphs clearly contemplate that, where a money purchase benefit is used to provide a fixed annuity, not backed by a specific asset such as an insurance policy, the annuity constitutes a defined pension benefit.

91. As Lord Walker also notes (para 80), it is clear that Parliament has enacted primary legislation, and the Secretary of State has initiated secondary legislation, on the assumption that a money purchase scheme (and a money purchase benefit) will not involve any shortfall of assets compared with liabilities. S.73 of PA 1995 provides for the assets of a salary related occupational scheme (i.e. not a money purchase scheme: see s.125(1)) "to be applies towards satisfying the liabilities in respect of pensions and other benefits (including increases in pensions)" in the order stated in subss. (2) to (4). Regulation 13 of the Occupational Pension Schemes (Winding Up) Regulations 1996 (S.I. 1996 No. 3126) provided that, in relation to a "hybrid" scheme, defined as one which was not a money purchase scheme, but under which some of the benefits which may be provided are money purchase benefits: "s.73 applies as if – (i) the liabilities of the scheme did not include liabilities in respect of those benefits, and (ii) the assets of the scheme did not include the assets by reference to which the rate or amount of those benefits is calculated".

92. The assumption in this subsequent legislation is that the rate or amount of benefits can be and is calculated by reference to specific assets, which can be extracted accordingly from the hybrid scheme. On the case presented by Mr Simmonds and the trustee, it is wholly unclear how this exercise can or should be performed, when and if there is a shortfall in the assets required to meet all liabilities under s.73 and in the assets specifically identifiable to meet liabilities for money purchase benefits. It is in particular unclear why the latter should be entitled to take out of the former sufficient to ensure that the latter are fully met, and, if that is not the case or is impossible, it is unclear what order of priority should apply to any claims to money purchase benefits against such assets as may be attributed to money purchase benefits.

93. While later legislators may have misunderstood the effect of earlier legislation, I repeat in relation to the inter-relationship of PSA 1993 and PSA 1995 what I said recently in the context of different legislation when giving a judgment with which Lord Walker, Lady Hale and Lord Collins agreed in *Bloomsbury International Ltd v Sea Fish Industry Authority* [2011] UKSC 25:

> "In the case of a statute which has …. been the subject of amendment it is not lightly to be concluded that Parliament, when making the amendment, misunderstood the general scheme of the original legislation, with the effect of creating a palpable anomaly (see eg the principle that provisions in a later Act in pari materia with an earlier may be used to aid the construction of the former, discussed in *Bennion on Statutory Interpretation*, 5th ed (2008), section 234)."

Lord Phillips in his judgment went perhaps even further: see especially para 61.

94. In the result, I am not persuaded that it is necessary or appropriate to read PSA 1993 (or subsequent legislation) as embracing within the concept of money purchase benefit, to some undefined and unclear extent, liabilities not matched with any specific asset held by the scheme. This applies as much to internal annuities granted by the scheme as to liabilities by way of guaranteed interest rates undertaken during the accrual of pension rights. Mr Nugee submitted that a distinction might if necessary, and in particular in the light of the points arising from ss.10(1), 28 and 102-108, be drawn between these two situations. I would be disinclined to draw such a distinction, when both involve exposure of the scheme to liabilities unmatched with any assets. My inclination would have been to allow the appeal on both questions identified in para 58 of Lord Walker's judgment.