



**SCOTLAND'S PENSIONS FUTURE:
WHAT PENSIONS ARRANGEMENTS
WOULD SCOTLAND NEED?**

A series of questions

26 April 2013

The ICAS viewpoint

A basic tenet of this paper is that ICAS members have a contribution to make to the debate on Scotland's future, its meaning and the implications for those in Scotland, the rest of the UK and beyond. ICAS has a duty to act in the public interest, which means we should contribute information and insights to the debate, based on the considerable interest and experience of our members in technical areas such as pensions, taxation, governance and regulatory matters.

Scotland's pensions future: what pensions arrangements would Scotland need? is the third in a series of papers which aims to do this: we are seeking to provide insights, ask the questions in key areas that those on different sides of the debate should address over the months leading up to the referendum on Scottish independence on 18 September 2014 and possibly beyond.

**Scotland's pensions future: what pensions arrangements would Scotland need?
A series of questions**

Contents	Page
Executive summary	4
Introduction	5
The questions	9
1. The state pension	9
2. Public sector pensions	11
3. Private sector pensions	14
• Regulation of work-based pensions	14
• Cross-border issues for occupational pension schemes in an independent Scotland	16
• Underlying tax issues arising from income tax raising powers available under the Scotland Act 2012	18
Conclusion	20

Executive summary

Proposals for constitutional change require the close attention of both the Scottish and UK Governments, as well as individual citizens, as they consider the possible implications for pensions arrangements in the event of a 'yes' vote in the referendum on Scottish independence. Given the nature of pensions, legacy issues would be a priority and this is a theme which runs through the three main sections of our paper:

- The state pension.
- Public sector pensions.
- Private sector pensions.

The following key questions are considered in our paper:

- *Who would make state pension payments in an independent Scotland and take responsibility for any entitlements built up prior to independence?*

State pension payments are made from general taxation, and are therefore unfunded, but entitlement is built up over many years. Responsibility for the "accrued" entitlement of those of working age living in Scotland to a state pension and the practicalities of making payments to those who are currently retired would be a major feature of any formal negotiations between the Scottish Government and the UK Government. From a public expenditure perspective the state pension is significant: in 2010-11, state pension payments of £82 billion were made by the UK Government, representing 40% of all social benefit payments and 13% of UK expenditure.

- *Who would be responsible for unfunded public sector pension liabilities built up prior to independence?*

At 31 March 2011, unfunded public sector pension liabilities of £893 billion were reported by the UK Government, representing 93% of all UK public sector pension liabilities and 37% of all UK liabilities. What would Scotland's share be in the opening balance sheet of an independent Scotland? For schemes which are Scottish based, the Scottish Public Pensions Agency has recently identified unfunded liabilities of £66 billion representing 70% of Scottish public sector pension liabilities identified so far. However, detailed work would be required to identify additional liabilities relating to Scottish-based members of UK-wide public sector pension schemes.

- *What pension regulation and protection arrangements would an independent Scotland need for private sector pensions?*

We believe it would be advantageous for the Scottish Government to continue, at least in the early years of an independent Scotland, to adopt existing UK arrangements for pension regulation and protection and develop these over time. However, this approach would bring its own challenges with the protection of defined benefit arrangements and the future of the UK Pensions Protection Fund, likely to be in the forefront of these.

- *How would EU solvency requirements for defined benefit and hybrid pensions schemes be met across the UK if Scotland became an independent country?*

If Scotland became an independent country there would be significant cross-border issues for schemes which currently operate UK-wide. Under EU law (as interpreted by UK legislation), schemes which operate in more than one country must fund their liabilities in full and any underfunding must be rectified immediately rather than through a staged recovery plan. Dealing with underfunding would have major cost and cash flow implications for employers with underfunded cross-border schemes.

Given the extent of the challenges involved and the level of public interest in pensions, we would urge the Scottish Government to begin the process of developing a robust plan for Scotland's pensions future before the outcome of the referendum is known. There would also be significant pensions issues for the UK Government to address during any period of transition towards Scottish independence, which require scoping prior to the referendum.

Introduction

Scope

Our paper, *Scotland's pensions future*, examines what pensions arrangements an independent Scotland would need. It looks in particular at what legacy issues would need to be addressed during any transition to an independent country in relation to the state pension, public sector pensions and other work-based pensions. Our approach is based on the assumption that if powers in respect of these areas were to be transferred to an independent Scotland, the transfer of these powers would take place on the day Scotland left the UK and became an independent country.

This paper also examines the potential tax consequences for pensioners and some of the potential impacts on pension providers arising from the Scotland Act 2012. This topic has some relevance to the independence debate. Implementation of the income tax raising powers under the 2012 Act is April 2016 which is just a month following March 2016: the date by which the Scottish Government anticipates Scotland could achieve independence in the event of a 'yes' vote.

We do not seek to identify every potential issue which may need to be considered in establishing pension arrangements following a 'yes' vote or to address broader policy matters. Neither do we address in detail the impact on the financial services industry in Scotland which provides and supports pension products. However, we look at where the Scottish Government may start in forming its approach to pensions.

An overall strategy towards pension provision would impact on the development of policies across a number of areas, for example, social policy, public sector spending and pensions law, regulation and protection. A transition towards an independent Scotland would also give rise to significant issues for the UK Government across a number of policy areas and we seek to highlight these, including the implications for the state pension which is already undergoing significant reform, the future of public sector pensions, the allocation of pension protection fund assets and liabilities and the operation of other defined benefit and hybrid pension schemes with members in Scotland and the rest of the UK. Finally we seek to raise public awareness of pension related issues in the context of the independence debate and to highlight the challenges which businesses, the public sector, pension scheme trustees and pension scheme administrators would need to address.

Scottish and UK Government approaches to the independence debate

Since the Edinburgh Agreement on 15 October 2012 paved the way for a referendum on Scottish independence to take place on 18 September 2014, both the Scottish Government and the UK Government have set out plans for the publication of a series of papers on Scottish independence, some of which will have a particular bearing on pensions issues.

On 5 February 2013, the Scottish Government published *Scotland's future: from the referendum to independence and a written constitution*¹. This is an initial discussion paper which will be followed by other papers outlining how responsibility in key reserved areas, such as pensions, would transfer to the Scottish Parliament in the event of a vote in favour of independence. The purpose of these papers is to encourage open debate in advance of the publication of a Scottish Government white paper on independence in the autumn of 2013. The paper also sets out the Scottish Government's assessment that Scotland could become an independent country in March 2016.

On 11 February 2013, the UK Government published *Scotland analysis: devolution and the implications of Scottish independence*². This is the first paper to be published as part of a cross-(UK) government programme of analysis also aimed at informing the debate on Scottish independence. The analysis programme will examine constitutional, economic and policy issues, including pensions. This first paper examines the UK's constitutional arrangements and the legal implications of independence.

¹ *Scotland's future: from the referendum to independence and a written constitution*: www.scotland.gov.uk/Publications/2013/02/8079.

² *Scotland Analysis: devolution and the implications of Scottish independence*: www.gov.uk/government/publications/scotland-analysis-devolution-and-the-implications-of-scottish-independence.

The wider context

While our paper does not set out in detail the UK Government's policy agenda on pensions or the potential impact of changes to solvency arrangements for pension schemes which are currently being driven by the EU, it does touch on the wider context throughout.

There have been two very recent developments at UK level which are likely to have a direct impact on the state pension and occupational defined benefit and hybrid pension schemes, which will progress in parallel, to a large extent, with the debate around independence and beyond during any period of negotiation, in the event of a 'yes' vote. These developments are:

- The UK Government's plans to reform the state pension; and
- The announcement by the UK Prime Minister of an in-out referendum on UK membership of the European Union.

In January 2013, the UK Government published a white paper *The single-tier state pension: a simple foundation for saving*³ and a draft pensions bill⁴ to implement the reforms. The ultimate aim of these reforms is to provide all pensioners with a flat rate state pension, which will provide a basis for further private saving towards a work-based pension. The reforms will bring an end to the second state pension and to contracting out. Managing legacy issues will be a major part of this reform process, with arrangements required to preserve existing rights. Current plans are to implement the state pension reforms from April 2016, a month later than the Scottish Government believes Scotland could become an independent country. Timetables routinely slip especially when dealing with complex issues about which people feel strongly, therefore, it is difficult to predict how far advanced reforms to the state pension may be by the time and in the event of Scotland becoming a separate country. Our paper explores questions around the continuing provision of the state pension in an independent Scotland.

Also in January 2013, the UK Prime Minister announced plans for an in-out referendum on UK membership of the European Union in 2017, which would follow a period of renegotiation of the UK's relationship with the EU.

Whether or not an independent Scotland is a member of the EU would have implications for the solvency arrangements for occupational pensions and the regulation of work-based pensions generally and around responsibilities and processes for state pension payments. If an independent Scotland exits the EU, even temporarily, there would be added complexity in relation to these particular pensions issues. It is possible that Scotland could exit the EU temporarily, if it becomes independent before it has negotiated entry to the EU and the accession process has been completed.

UK defined benefit and hybrid pension schemes are governed by the solvency rules set out in the EU's Pensions (IORP) Directive, which include rules about the funding of cross-border schemes. The Directive places more stringent solvency rules on schemes operating across borders than it does on those which operate within a single state. If Scotland becomes an independent country, schemes which operate in both Scotland and in the rest of the UK would become cross-border schemes. Therefore the timing of any changes to constitutional arrangements around Scottish independence and EU membership would be a significant issue for employers with cross-border schemes and the trustees of these schemes to manage. Our paper examines the impact on defined benefit schemes and hybrid schemes which would become cross-border schemes in the event of Scottish independence.

³ DWP information on state pension reform including the white paper, *the single-tier pension: a simple foundation for saving*: www.dwp.gov.uk/policy/pensions-reform/state-pension/.

⁴ DWP information on the draft pensions bill: www.dwp.gov.uk/policy/pensions-reform/the-draft-pensions-bill/.

The following table places the pensions reform agenda in relation to other key events in the context of the debate on Scottish independence.

Pensions reform in relation to key events

1 October 2012 – The largest UK employers auto-enrol staff, who are eligible job holders, into a pension scheme.

15 October 2012 – The Edinburgh Agreement.

January 2013 - UK Government publishes its state pensions white paper and draft bill and announces plans to renegotiate the UK's relationship with the EU leading to an in-out referendum.

February 2013 – The UK and Scottish Governments publish their first discussion papers on independence.

12 February 2013 – The Privy Council issues a Section 30 Order to enable the referendum on Scottish independence to go ahead.

March 2013 – The Scottish Government publishes its Referendum Bill.

Spring/summer 2013 – Public Service Pensions Bill to receive Royal Assent.

Summer 2013 – The European Commission considers whether insurance industry solvency requirements (Solvency II) should be applied to private sector occupational defined benefit and hybrid pension schemes.

November 2013 – The Referendum Bill is expected to receive Royal Assent.

Autumn 2013 – The Scottish Government is to publish its independence white paper.

18 September 2014 – Referendum on Scottish independence.

7 May 2015 – UK general election.

March 2016 – The Scottish Government envisages the establishment of Scotland as a separate country in the event of a 'yes' vote in 2014.

April 2016 – UK Government anticipates state pension reforms are implemented.

April 2016 – Income tax raising powers under the Scotland Act 2012 come into force, if Scotland remains part of the UK.

5 May 2016 – Scottish parliamentary elections.

2017 – Possible UK referendum on membership of the EU.

1 April 2018 – All UK employers must enrol staff who are eligible job holders into a pension scheme.

An independent Scotland's opening balance sheet

Both the Scottish and UK Government recognise that negotiations leading to independence would involve identifying respective shares of the UK's assets and liabilities.

The Scottish Government states in *Scotland's Future: from the referendum to independence and a written constitution* that:

“Issues to be resolved would include the division of financial and other assets and liabilities including oil revenues and assignation of other tax revenues, military bases and overseas assets....”

The UK Government states in *Scotland Analysis: devolution and the implications of Scottish independence*:

“The continuing UK would approach negotiations in good faith and, in the interests of its citizens, would need to seek to ensure that a fair settlement applied to assets and liabilities (such as national debt).”

Scotland’s opening balance sheet and off balance sheet commitments would be determined to an extent by how a constitutional settlement addresses both state and public sector pension commitments acquired by an independent Scotland. The opening balance sheet would be a key factor in the development of expenditure plans and government policies on all areas of responsibility, including policies around taxation and borrowing.

This paper considers information in the public domain on annual expenditure on state pensions and public sector pension liabilities at UK level and Scotland-only information on the size of some public sector pension schemes catering for employees who work in devolved areas. However, complete Scotland-only information on state and public sector pension provision is not readily available, in part due to the reserved nature of the state pension and a number of public sector pension schemes being UK-wide. A crude analysis based on relative populations may not provide a sufficiently robust starting point for illustrating the pension liabilities and commitments which Scotland may acquire following independence. However, according to the June 2011 census⁵, the total UK population is 63.2 million and Scotland’s population is 5.3 million or 8.4% of the total.

The questions

In order to establish what pension arrangements would be needed in a Scotland which had sole responsibility for these, we identify some key questions which need to be asked and answered.

⁵ Office of National Statistics presentation of the 2011 Census results: www.ons.gov.uk/ons/guide-method/census/2011/uk-census/index.html.

The questions

1. The state pension

Issues for the state pension in an independent Scotland

- What state pension arrangements would the Scottish Government need to introduce?
- What transitional arrangements would be needed?
- What would the Scottish Government receive, if anything, from the UK Government by way of providing for those of working age with “accrued” entitlement to a state pension?

History and reform

More than three decades after the idea of a public pension system was mooted, the 1908 Old Age Pensions Act was passed to provide limited financial support to an aging population. The first public pension payments were made on 1 January 1909 to those over 70 deemed to be eligible, following a process of means testing. Over 100 years and several reforms later, the current state pension system is poised for further change following the UK Government’s plans to introduce a flat rate state pension for all retirees. In January 2013, the UK Government published *The single-tier pension: a simple foundation for saving* and a draft Pensions Bill. The proposed reforms are now due to be introduced in April 2016, with arrangements being developed to preserve the pension rights of individuals up to that date.

UK-wide state pension reform means that the starting point for developing a Scottish state pension system is uncertain. Would the current UK system provide the starting point or would the proposals for the single-tier state pension add further complexity? The architecture for delivering the single-tier state pension would be on-going during any period of negotiation between the Scottish Government and the UK Government, in the event of a vote in favour of independence, and a new UK Pensions Act is likely to be passed. However, implementation of the single-tier pension in April 2016 is a month after the date by which the Scottish Government anticipates independence could be achieved. How would both the Scottish Government and the UK Government reassure Scottish pensioners and deferred pensioners about the future of the state pension following independence? Would it be possible to provide any assurance to individuals about whether or how their state pension would be affected during periods of state pension reform at UK level and possible constitutional reform at both UK and Scotland level?

Obligations following independence

Following independence, what would the Scottish Government’s obligations be to pensioners and those yet to retire and how would these be met? How would the introduction of a single-tier pension impact on the “accrued” entitlement of those of working age living in Scotland? Currently entitlement to the state pension is built up through an individual’s national insurance contributions, but payments are made from general taxation. How would the Scottish Government approach the establishment of a national insurance system for an independent Scotland?

Under accounting standards⁶ there is no requirement to measure and recognise the “accrued” entitlement of all individuals to a state pension in the UK’s Whole of Government Accounts⁷ and, in reality, national insurance assets are not the assets used to generate state pension payments. Therefore, with no assets to fund the liabilities, how would the “accrued” entitlement of individuals be addressed in any future constitutional settlement?

⁶ The accounting standards applied by the UK public sector are EU-adopted International Financial Reporting Standards (IFRSs).

⁷ Whole of Government Accounts: www.hm-treasury.gov.uk/psr_government_accounts.htm.

In terms of context, state retirement pensions of £74 billion and pension credits of £8 billion, totalling £82 billion, were paid in 2010-11 (2009-10: £71 billion and £8 billion respectively, totalling £79 billion)⁸. In both of these financial years, pension payments and pension credit combined represent 40% of social benefit payments and 13% of all UK expenditure. Scotland-only figures for the cost of state retirement benefits are not in the public domain but it is likely that Scottish and UK Governments have a means of establishing the historic cost of the state pension and of predicting future costs using population statistics. However, calculations of the future cost of the state pension in an independent Scotland would depend on the policy of a future Scottish Government.

Transitional arrangements for the state pension

What would be the nature of any transitional arrangements? Should existing pensioners continue to be paid by the UK, either directly or indirectly via the Scottish Government? Should those who have contributed to the UK system through national insurance contributions receive part of their pension from the UK, either directly or indirectly? What arrangements would be required to transfer records from the Department of Work and Pensions (DWP) to a Scottish equivalent? What work would need to be undertaken to ensure that data is transferred completely and accurately? The answer to these questions would impact on negotiations about the transfer of obligations to pay state pensions to the Scottish Government. The completeness and accuracy of individual state pension records held by the DWP would be an issue for both Governments as the quality of records has resulted in an almost permanent qualification of the DWP's annual accounts by the Comptroller and Auditor General (C&AG) due to estimates of fraud and error, resulting in both over and underpayments of state pension.

Membership of the European Union or loss of membership, even for a short time, would also impact on state pension arrangements. There are existing rules which apply in circumstances where an individual's entitlement to a state pension arises from working in more than one European Economic Area (EEA) state. However, if Scotland was not an EEA state, even for a period of time, separate arrangements would likely be needed to ensure state pension payments continue and individuals' accrued entitlements are preserved.

At present, if an individual has paid national insurance in the UK, the DWP will make inquiries before the individual meets the UK state retirement age as to any national insurance paid or any periods of residence in another state. If the individual is living in another EEA state and has also worked in that state any entitlement to the UK state pension will be paid through the pension institution in that state. However, if an individual has not previously worked in the state he or she has retired to, a claim for UK state pension should be made to the UK Government's International Pensions Centre. What arrangements would need to be introduced by the Government of an independent Scotland and a rest of the UK Government for those individuals whose state pension they were responsible for paying and to manage the payment of cross-border state pensions?

⁸ Figures for the payment of state retirement pensions include personal pension payments made by the National Insurance Fund, for example, to members of contracted out money purchase schemes. In 2010-11, £2.3bn in personal pension payments were made (2009-10: £2.6bn). See note 9 of the National Insurance Fund Account (Great Britain) 2010-11 www.gov.uk/government/uploads/system/uploads/attachment_data/file/89249/ni-fundaccount10-11.pdf.

2. Public sector pensions

Issues for public sector pensions in an independent Scotland

- What legislative and regulatory framework would Scotland need to support the on-going administration of public sector pension schemes?
- How would unfunded pension liabilities be shared, for example, unfunded liabilities arising from the Armed Forces Pension Scheme, the NHS in Scotland Pension Scheme and the Principal Civil Service Pension Scheme?

The policy-making and legal framework for public sector pensions

Pensions policy and pensions law and regulation around occupational pension matters are primarily reserved matters. Pension arrangements for Scottish public sector pensions must comply with UK primary legislation, for example, the forthcoming Public Service Pensions Act will apply. Although there are separate Scottish regulations for Scottish-based schemes these must be compatible with UK primary legislation. According to written evidence from the Scottish Public Pensions Agency (SPPA) to the House of Commons Scottish Affairs Select Committee in February 2013⁹, the Scottish Government has legislative competence for a small number of public sector schemes, which represent less than 1% of devolved activities.

An independent Scotland would acquire responsibility for occupational pensions policy, law-making and regulation including public sector pensions. We consider the implications for private sector work-based pensions in the next section of this paper. With regard to public sector pensions, the Government of an independent Scotland would be responsible for the legal, regulatory and administrative framework for public sector pensions in respect of matters which are currently devolved and those which are currently reserved. Public sector pensions are provided as part of an individual's contract of employment therefore it is likely that existing pensions law impacting on public sector pensions would form the basis of the law in an independent Scotland.

Arrangements for the administration of public sector pensions would need to be expanded to encompass those employed or previously employed to provide public services in areas which had been reserved, for example, the armed services and foreign affairs. However, transitional arrangements would need to be robust and carefully scoped, for example, would a rest of the UK Government continue to pay the pension of a retired member of the UK-wide Principal Civil Service Pension Scheme (PCSPS) who lived and worked in Scotland? Also, which Government would be responsible for paying the pension of a retired PCSPS member who worked in England but who lives in Scotland during their retirement? We explore these issues further under the heading *managing the separation of pension liabilities and assets*.

Public sector employees, deferred members and pensioners would be looking to the Government of an independent Scotland and a rest of the UK Government to ensure that there are robust transitional arrangements in place where responsibility for administering and paying pensions moves from the UK to an independent Scotland. A key feature of these transitional arrangements would be the complete and accurate transfer of member records so that those receiving pensions continue to do so uninterrupted. However, the quality of existing member records may provide additional challenges; for example, the Comptroller and Auditor General's (C&AG's) qualified his auditor's report on the 2011-12 Civil Superannuation accounts¹⁰.

⁹ Written evidence submitted by the Scottish Public Pensions Agency to the Scottish Affairs Commons Select Committee on the referendum of separation for Scotland, in response to the Committee's call for evidence issued on 6 February 2013: www.publications.parliament.uk/pa/cm201213/cmselect/cmselect/cmselect/writev/ref/m06.htm.

¹⁰ Report of the Comptroller and Auditor General on the 2011-12 Civil Superannuation accounts: www.nao.org.uk/publications/1213/civil_superannuation_2011-12.aspx.

The Civil Service Superannuation accounts report the financial results of the PCSPS and a number of other small public sector pension schemes. The C&AG reported significant improvements in member records but still qualified his opinion in two respects:

- First, sufficient records were not available or provided to confirm that all pensioners or other beneficiaries received the correct payments, in accordance with scheme rules.
- Secondly, given the concern over the records held, assurance was sought that the estimated pension liability of £144 billion, based on the PCSP's membership records, was reasonable. The evidence presented was insufficient to provide that assurance.

With regard to the administration of public sector pensions in an independent Scotland, there would be an expanded role for the SPPA, or a successor body. The extent of any expanded role would depend on future decisions and the extent to which responsibility is assumed for paying pensions where entitlement was built up in relation to services which were previously reserved. Currently, the SPPA's principal role is to administer the pensions, premature retirement and injury benefits schemes for employees of the National Health Service in Scotland Scheme (NHSSS) and for members of the Scottish Teachers' Superannuation Scheme (STSS). It also has responsibility for providing policy advice to Scottish Ministers on public sector pensions for these schemes plus those for local government, the police service and the fire service; and for developing the regulations for each of these schemes.

The UK's pension liabilities

The public sector operates a range of defined benefit funded and unfunded pension schemes for past and present public sector staff: there are no defined contribution public sector pension schemes operating in the UK. Some schemes are administered by the UK Government, such as the PCSPS and the Armed Forces Pension Scheme; others are administered by devolved administrations, other public sector entities, such as local authorities and independent trustees. At 31 March 2011, public sector pension liabilities, both funded and unfunded, of £960 billion¹¹ (at 31 March 2010: £1,135 billion¹²) were reported for the whole of the UK. Public sector pension liabilities represent 40% (at 31 March 2010: 46%) of all liabilities reported at 31 March 2011: total liabilities being £2,421 billion (at 31 March 2010: £2,477 billion). Unfunded pension schemes are without assets and retirement benefits are paid from employer and employee contributions made in a particular year, topped up by current taxation, whereas funded schemes have scheme assets which are used to pay retirement benefits. Funded schemes also have sponsoring employers who are responsible for any shortfalls in scheme funding.

Unfunded pension liabilities

What arrangements need to be established to ensure that unfunded liabilities are shared equitably between an independent Scotland and the rest of the UK? Unfunded pension liabilities of £893 billion represent 93% (at 31 March 2010: 90%) of the total pension liabilities reported and only crystallise at UK level i.e. these are not recognised in the accounts of individual public sector employers. These unfunded liabilities reflect the net present value of amounts owed to current pensioners, deferred pensioners and current employees who will receive a pension on retirement. The liabilities are calculated in accordance with accounting standards and could form part of any analysis as to how these should be split between Scotland and the rest of the UK in the event of constitutional change. Complete and accurate information on the public sector pension liabilities to be transferred would be required to establish the opening financial position of an independent Scotland, given their likely significance to the overall position and to future financial planning considerations. Negotiations around the transfer of responsibility for any unfunded liabilities are of particular importance given that there are no assets held at either UK level or Scottish Government level to pay for unfunded pensions as they fall due.

¹¹ 2010-11 Whole of Government Accounts: www.hm-treasury.gov.uk/psr_government_accounts.htm.

¹² 2009-10 Whole of Government accounts: www.hm-treasury.gov.uk/psr_government_accounts.htm.

More detailed underlying information is likely to be available, for example, the SPPA's recent written evidence¹³ to the Scottish Affairs Commons Select Committee provides some information on the size of public sector pension schemes and pension liabilities for those employers engaged in devolved activities. Information provided by the SPPA is analysed in the following table. It excludes information on the pensions of Scottish Government employees (as the Scottish Government participates in the UK-wide PCSPS) and on the Scottish Parliamentary Pension Scheme for MSPs and office-holders of the Scottish Parliament.

Scheme classification	Number of employed members	Number of deferred members	Number of pensioner members	Total	Pensions paid (£bn)	Estimated liabilities (£bn)
Funded (LGPS only)	218,232	100,924	139,085	458,241	0.97	25.06
Unfunded	263,629	69,960	160,120	493,709	2.17	60.22
Scottish NDPB schemes*	2,778	0	1,708	4,486	0.02	0.70
Total	484,639	170,884	300,913	956,436	3.16	85.98

*Information not analysed between funded and unfunded schemes

The table illustrates that approximately 52% of scheme members engaged in a wide range of devolved activities in 2011-12 were members of unfunded pension schemes. The estimated pension liabilities of these unfunded schemes are at least £60.22 billion or around 70% of the total estimated pension liabilities reported by the SPPA in its written evidence. Looking back at the unfunded pension liabilities reported within the UK's Whole of Government Accounts, unfunded pension liabilities amount to over 90% of UK-wide public sector pension liabilities, compared to around 70% for devolved activities. This difference of around 20% may reflect that reserved activities, which would be transferred to the Scottish Government following independence, are more likely to be in areas where unfunded pension arrangements currently operate. The balance of funded and unfunded liabilities in an independent Scotland would of course depend on the Government of an independent Scotland continuing with the same or similar pension arrangements to those currently provided by the UK Government in reserved areas.

Managing the separation of liabilities and assets

For schemes which are already Scottish based, such as the Scottish Local Government Pension Scheme (LGPS) and the NHS in Scotland Scheme and the Scottish Teachers' Superannuation Scheme, the impact of constitutional change would not be uniform. For example, the NHS and Teachers schemes are unfunded schemes underwritten by the UK Government, which along with the Scottish Ministers, determines the scheme regulations, whereas Scottish LGPS funds, while these also have a legislative framework which must comply with UK law, are funded and administered solely within Scotland and therefore scheme liabilities and assets would remain in situ following independence.

The issues arising for both the Scottish and UK Governments to consider in relation to unfunded public sector schemes would be similar to those arising for the state pension. What would the Scottish Government's obligations be to pensioners and those yet to retire and how would these be met? What would be the nature of any transitional arrangements? Should existing pensioners continue to be funded by the UK? Should those who have "accrued" entitlement, through past service and employee contributions, prior to a transfer of powers receive part of their pension from the UK? Where there is no fund to meet the liabilities, how would the "accrued" entitlement of individuals be recognised in a future constitutional settlement?

¹³ Written evidence submitted by the Scottish Public Pensions Agency to the Scottish Affairs Commons Select Committee on the referendum of separation for Scotland, in response to the Committee's call for evidence issued on 6 February 2013: www.publications.parliament.uk/pa/cm201213/cmselect/cmsscota/writev/ref/m06.htm.

3. Private sector pensions

Regulation of work-based pensions

- Would new industry bodies be set up: for example, to perform the functions of The Pensions Regulator and the Pension Protection Fund?
- What would happen to existing pension law?
- Would current UK arrangements be replicated or replaced: for example, what would happen to auto-enrolment arrangements?

UK pensions policy, regulation and protection

As a consequence of the Maxwell scandal of 1991-92, the UK Government introduced regulatory and compensation schemes for pensions to protect those contributing to private sector schemes. Since then pensions law has grown in length and complexity. Today's challenges differ with the current UK focus being on ensuring that citizens provide for their own retirement and on the sustainability of defined benefit pension schemes.

The table below illustrates how different types of private pension arrangement are currently regulated within the UK.

Occupational defined benefit (DB) trust-based pension schemes	Occupational defined contribution (DC) trust-based pension schemes	Work-based personal pensions	Individual personal pensions
Occupational		Personal	
Employer-sponsored			Non-sponsored
The Pensions Regulator's remit (work-based pension schemes)			
		Financial Conduct Authority's remit	

Source: The Pensions Regulator

The Pensions Regulator (TPR) is the UK regulator of work-based pensions. Under pensions law TPR has four main statutory objectives¹⁴:

- To protect the benefits of members of work-based pension schemes.
- To promote the good administration of work-based pension schemes.
- To reduce the risk of situations arising that may lead to claims for compensation from the Pension Protection Fund.
- To maximise employers' compliance with auto-enrolment duties.

An additional statutory objective for TPR was announced by the Chancellor of the Exchequer in the 2013 Budget: the new objective will be to support scheme funding arrangements that are compatible with sustainable growth for the sponsoring employer. The new objective will be reviewed six months following its implementation date, which has yet to be confirmed.

The law on pension auto-enrolment requires employers to enrol eligible job holders into a pension, which can be the employer's existing pension arrangement or a new arrangement introduced specifically for this purpose. The largest employers were required to start auto-enrolling eligible job holders in October 2012 and the smallest will be required to do so by April 2018. Auto-enrolment and the proposed state pension reforms are key elements of the UK Government's policy on retirement planning and saving, the former being to increase the number of citizens contributing to their own pension while the latter, through removing means testing, is designed to provide a platform to facilitate more private saving.

¹⁴ The first three objectives are set out in the Pensions Act 2004 and the fourth objective is set out in the Pensions Act 2008.

The Financial Services Authority (FSA) was responsible for regulating UK financial services until April 2013. On 1 April 2013, financial services regulation officially transferred to two successor bodies: the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). The FCA has stepped into the FSA's role in relation to work-based personal pensions and individual personal pensions. This paper does not address the wider issue of financial services regulation in an independent Scotland; however, we understand that under EU law Scotland would have to have its own financial services regulator or regulators.

The Pension Protection Fund (PPF), like TPR, was established by the Pensions Act 2004. Its role is to pay compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation.

There is a wider issue as to how the Government of an independent Scotland would ensure that there is a comprehensive body of law and regulation to enable civil society to continue to operate from day one. The operation of law and regulations for private sector pensions following a transition to an independent Scotland may have similar features to other policy areas which are currently reserved. However, we highlight a number of issues below in the context of private pensions.

Transitional arrangements for pension regulation, protection and auto-enrolment

Both TPR and the PPF are UK institutions and whether or how their functions would be performed within an independent Scotland would depend on the Scottish Government's and UK Government's approach to UK institutions following any constitutional change. Adopting existing UK law and sharing institutions may be an option in the short to medium-term for an independent Scotland. However, consideration would need to be given as to whether there were any specific legal barriers to the cross-border regulation and protection of private sector defined benefit pensions. An independent Scotland's status with regard to EU membership is also likely to have an impact on how any sharing arrangements could or should operate.

If there are no legal barriers to sharing institutions which provide pension regulation and protection, how would shared services arrangements be structured and funded? Would the UK charge Scotland for shared services or would these be jointly funded supranational institutions? Could Scotland suffer a VAT charge on shared services arrangements if it purchased the services of TPR and the PPF from the rest of the UK i.e. if TPR and the PPF remained rest of the UK institutions in the event of Scotland becoming an independent country?

Alternatively could Scottish equivalents of TPR and the PPF be established to coincide with the implementation of any constitutional change, along with new laws? Would a Scottish PPF take on responsibility for paying pensions in relation to Scottish schemes which have already been transferred to the UK PPF?

There are likely to be specific challenges in respect of pension protection even if the PPF is a shared institution, as protection arrangements may need to operate separately for Scottish based and rest of the UK-schemes to reflect the existence of two separate countries, two bodies of law and the impact of EU solvency requirements, which may have different implications depending on whether an independent Scotland's membership of the EU remains unbroken. Also, schemes which continue to operate across border would need to be accommodated within the new arrangements.

Assuming that separate protection arrangements would be required, at some future date, if not immediately after independence in the event of a 'yes' vote, a separate Scottish protection fund would need to take over the assets and liabilities of Scottish pension schemes which had transferred previously to the UK PPF, as well as the net investments and returns to date on those schemes' assets.

How would Scottish pension schemes be identified and would the UK PPF pay over to a separate Scottish fund the levies raised from Scottish pension funds to date, together with the investment returns on them? How would any cross-border schemes which had entered the UK's PPF be identified and what steps would be needed to identify separately Scottish and rest of the UK assets and liabilities? Where cross-border schemes have paid PPF levies, how would the levies and investment returns on these be split between the Scotland and rest of the UK funds. What difficulties would businesses with cross-border schemes face in disentangling Scottish and rest of the UK information which would be needed to assist this process?

With regard to pension auto-enrolment, would the Scottish Government continue with existing arrangements for auto-enrolment? If so, what arrangements would be required to maintain this policy? Would the Scottish Government develop its own master trust, an equivalent of NEST (National Employment Savings Trust)? What arrangements would be required to ensure existing master trusts can operate across border or would this not be possible? What steps would be taken to protect the pension pots of individual citizens?

Cross-border issues for occupational pension schemes in an independent Scotland

- What solvency requirements would need to operate cross-border between Scotland and the remainder of the UK, if Scotland remains within the EU?
- What solvency requirements for pension funds should operate, if Scotland does not remain within the EU?

Solvency rules for occupational pension schemes

Occupational pension schemes within the EU are required to comply with the solvency requirements set out in the Pensions (IORP) Directive (as interpreted by UK legislation)¹⁵. There are specific requirements which apply to occupational schemes which operate across the borders of EU member states. These cross-border requirements would apply if an independent Scotland remained within the EU. What are these rules and what options would be available to the Scottish Government and the UK Government for implementing these?

The Pensions (IORP) Directive provides that an institution for occupational retirement provision (IORP, commonly known as an occupational pension scheme in the UK) that wishes to accept contributions from an employer located in another EU member state – in other words, to operate 'cross-border' – must:

- Have the prior authorisation and approval of the relevant authority in its home member state¹⁶;
- Be fully funded at all times on a technical provisions basis¹⁷. Unlike a domestic scheme, a cross-border scheme may not rectify underfunding through the use of a recovery plan; and
- Comply with the 'social and labour laws' of the other relevant member state¹⁸.

Pension scheme trustees can be penalised for a failure to comply with these requirements¹⁹.

While the requirements to obtain prior authorisation (entailing a process of application, authorisation and approval) and to comply with relevant 'social and labour laws' present an additional compliance requirement for cross-border schemes, the main cross-border issue arising from the Pensions (IORP) Directive relates to funding and so is of greatest relevance to defined benefit and hybrid schemes.

¹⁵ Directive 2003/41/EC dated 3 June 2003 on the Activities and Supervision of Institutions for Occupational Retirement Provision.

¹⁶ Article 20, Pensions (IORP) Directive. In the UK the relevant authority is The Pensions Regulator.

¹⁷ Article 16(3), Pensions (IORP) Directive.

¹⁸ Article 14, Pensions (IORP) Directive.

¹⁹ Article 20(10), Pensions (IORP) Directive.

Considerations for an independent Scotland within the EU

Were Scotland to separate from the UK and join the EU as a member state in its own right, a scheme located in Scotland accepting contributions from an employer located in the rest of the UK (or vice versa) would be deemed to operate cross-border and therefore be subject to the requirements of the Directive, as implemented in the relevant member state²⁰. Currently, a large number of UK pension schemes do not meet the statutory funding objective (i.e. do not have sufficient assets to cover the scheme's technical provisions)²¹.

It can be expected that a significant number of these would become cross-border schemes if Scotland was an EU member state in its own right. Therefore, the potential impact on funding requirements for employers operating defined benefit or hybrid schemes across the UK is likely to be substantial, although we have not been able to ascertain the number of schemes which would be affected. Due to the UK's approach to the application of EU law in this area, cross-border schemes require annual rather than triennial actuarial valuations. Having to conduct annual actuarial valuations would place additional regulatory and cost burdens on schemes caught by cross-border solvency requirements as a consequence of Scotland becoming an independent country. Some smaller EU countries interpret the solvency requirements differently but on the basis that an independent Scotland is likely to adopt UK pensions law at least for a period, the current solvency rules would continue to apply in both jurisdictions.

If an independent Scotland with EU membership was seeking to implement the requirements of the Pensions (IORP) Directive, it would need to consider how the impact of the cross-border requirements on the funding of occupational pension schemes might be mitigated, for example by seeking an exemption for existing UK-wide pension schemes or a lengthy grace period for the achievement of full funding on a technical provisions basis.²² With many schemes operating with recovery plans spanning 10+ years, the grace period sought by the business community may be outwith the scope of the Scottish Government's discretion in implementing the Pensions (IORP) Directive.

In common with many other areas of the law, the proper application of the Pensions (IORP) Directive to a scheme located in Scotland accepting contributions from an employer located in the rest of the UK (or vice versa) would require a clear system to determine whether a scheme operating in both Scotland and in the rest of the UK is a Scottish scheme or a rest of the UK scheme. This would allow schemes to ascertain whether they are subject to the Scottish or rest of UK legal and regulatory requirements and, whether they are receiving contributions from an employer located in another EU member state.

This is a significantly complex issue and there would be additional burdens on business which become cross-border businesses, arising from the application of the Pensions (IORP) Directive. Could this result in pension schemes being split into Scottish schemes and rest of the UK schemes? Is there a mechanism for splitting schemes and, if so, what are the risks to scheme members of doing so? How would the splitting of schemes be managed from a statutory debt perspective? What would be the main elements of the process and who would bear the costs?

²⁰ In the UK, the requirements of the Pensions (IORP) Directive were implemented in sections 287 to 295, Part 7 of the Pensions Act 2004 and the Occupational Pension Schemes (Cross-border Activities) Regulations 2005 (S.I. 2005/3381).

²¹ The PPF 7800 Index published 31 May 2012 notes that the average funding ratio (assets as a percentage of section 179 liabilities) of the UK's PPF-eligible defined benefit schemes is 76.8%. The section 179 funding basis is less onerous than the section 222 (assets against technical provisions) funding basis and therefore a greater number of schemes would be underfunded against their technical provisions.

²² Prior to the Pensions (IORP) Directive, employers with subsidiaries in other member states (other than those with subsidiaries in the Republic of Ireland which received a level of exclusion due to a reciprocal agreement between the UK and Ireland) were required to establish separate schemes in each member state in which a subsidiary was based. The Pensions (IORP) Directive enabled, for the first time, companies operating in a number of member states to consolidate their pension arrangements in one member state. During the consultation process for the UK's implementing legislation, the impact of the Directive's cross-border funding requirements on existing UK/Irish cross-border schemes was considered. The Commission refused to exclude existing cross-border schemes operating in the UK and the Republic of Ireland from the scope of the obligations under the Directive, though ultimately the UK implementing legislation provided for a three year grace period for existing cross-border schemes to reach full funding levels.

Considerations for an independent Scotland outside the EU

The implications for the on-going operation and solvency requirements of Scottish based cross-border schemes, if an independent Scotland is outside of the EU, even temporarily, are less clear. The IORP Directive would cease to apply to Scottish based defined benefit and hybrid pension schemes, although it would continue to apply to rest of the UK based cross-border schemes which would need to be fully funded. Assuming that membership of the EU would be pursued by the Government of an independent Scotland, establishing a solvency regime which met with the EU's requirements would seem an appropriate starting point for any Scotland-only solvency regime, should this be necessary.

Underlying tax issues arising from income tax raising powers available under the Scotland Act 2012

- What arrangements need to be established to ensure tax reliefs are properly applied, particularly under the relief at source process?
- What arrangements should be introduced to protect those with purchased life annuities when their tax status is uncertain?

Income tax powers under the Scotland Act 2012

Under the Scotland Act 2012, the Scottish Parliament is set to implement new income tax powers from 1 April 2016. However, in the event of a vote in favour of independence in September 2014 and the Scottish Government then pursuing a timetable to achieve independence by March 2016, additional work would need to be undertaken to consider how the income tax raising mechanisms with the Scotland Act would be impacted by any arrangements made between the Scottish Government and the UK Government around the collection and distribution of income tax to an independent Scotland.

Implications for taxpayers and pension administrators arising from the Scotland Act 2012

Differing rates of income tax in Scotland from the rest of the UK will add complexity to the tax affairs of some individuals contributing to a pension scheme, in particular Scottish taxpayers who are members of pension schemes which operate the relief at source (RAS) process. Differing rates will also place additional administrative burdens on the pensions industry and this has been recognised by HMRC.

Assuming the Scotland Act 2012 is implemented as currently timetabled, it is quite possible that the Scottish rate of income tax and the UK rate of income tax could remain the same after the acquisition of these new powers. However, both individuals and the pensions industry need to be geared up to ensure that pensions tax relief is received at the individual's marginal rate of tax. HMRC is exploring with the industry how the administrative burden can be minimised.

There will be a demand from taxpayers who need to understand how the introduction of differing rates of income tax would affect their tax affairs, including pension tax relief claimed by them or on their behalf, and how they should respond to this. It would be undesirable to increase the number of taxpayers having to complete self-assessment returns in the event that their tax status was not identified correctly on payroll or pension scheme systems or to increase interventions by employers and pension providers to address errors.

Pensions schemes using the net pay arrangement

Where pension contributions are deductible from pay before the employee's individual PAYE tax calculation is applied, tax relief is automatically given to the employee at their marginal rate of tax. This is known as the net pay arrangement. The operation of this arrangement should not be affected by differences between the Scottish rate of income tax and the UK rate as tax relief will continue to be received at the employee's marginal tax rate. This of course assumes that all employees know at the beginning of the tax year that they are a Scottish or UK taxpayer and are correctly identified as such by their employer's payroll system. Our earlier paper, *Scotland's Tax Future*²³ explores the question "Who should pay tax in Scotland?" and considers the challenges which exist where individuals do not necessarily know their tax status until after the end of the tax year.

²³ Scotland's Tax Future - www.icas.org.uk/News/Latest_News/Scotland_and_tax_ICAS_poses_fundamental_questions.

Pension schemes using the relief at source process

HMRC's Technical Note *Clarifying the scope of the Scottish rate of income tax*²⁴ (May 2012) identifies the types of pension scheme which would be affected by differing rates of income tax and makes a commitment to improving the relief at source (RAS) process. Intended improvements involve incorporating the impact of the Scottish rate within the RAS process: this would minimise the cost to industry, while ensuring that taxpayers receive the right amount of relief at the right time.

The RAS process is used by:

- Non-occupational pension schemes such as personal pensions, stakeholder pensions and group personal pensions.
- Occupational pension schemes not using the net pay arrangement.
- The National Employment Savings Trust (NEST) and other master trusts.

Where pension contributions are paid net of basic rate tax relief to the pension scheme and the scheme administrator claims the basic rate tax relief from HMRC, the tax relief is paid directly to the pension scheme. Individuals paying the higher and the additional rates of tax can claim any further tax relief through the self-assessment process. Individuals and pension scheme administrators need to know their tax status so that they can ensure that tax relief is correct. What support could or should the Scottish Government or UK Government give to individuals affected by RAS arrangements to ensure that they receive the correct amount of tax relief on their contributions? Even if the Scottish Parliament votes for income tax rates to be consistent with the rest of the UK, pension providers' processes for dealing with potential differences would need to be established to ensure a level of preparedness should this position change in the future. While HMRC's commitment to improving the RAS process is to be welcomed, the detail of how this is to be achieved has yet to be worked out. The operation by NEST and other master trusts of the RAS process will impact on the number individuals who would be affected by differing tax rates and this will grow over time as more and more employers reach their staging date for pension auto-enrolment. The DWP estimates that around 11 million people in the UK will be eligible to auto-enrol over the implementation period, with between 6 million to 9 million choosing to remain auto-enrolled. Many of these will be enrolling in master trust schemes.

There is a potential pitfall for DC scheme members in the year they purchase an annuity. A member of a DC pension scheme operating on a relief at source basis who was enjoying tax relief based on one income tax rate (say the Scottish rate) during a tax year but it was subsequently determined that he or she should in fact have been a "rest of the UK taxpayer" for that tax year and therefore tax relief should have been based on the rest of the UK income tax rates. If he or she retires and his or her benefits are secured by the purchase of an annuity prior to the necessary adjustments being made, assuming differing tax rates, he or she will have received too much or too little tax relief. The issue is then which jurisdiction settles that over or under payment.

²⁴HMRC's Technical Note 'Clarifying the scope of the Scottish rate of income tax' (May 2012) - <http://www.hmrc.gov.uk/news/news-calman.htm>.

Conclusion

While it is too soon to draw any firm conclusions about Scotland's pensions' future in the event of a 'yes' vote, it is possible to begin to scope those issues which both the Scottish and UK Governments must consider during a period of potentially radical constitutional change. It is for both Governments to engage with citizens and other pensions stakeholders to prepare a way forward by managing legacy issues in a way that protects retirement incomes and the arrangements which deliver these.

Security in retirement is a hugely significant issue for individuals and for both Governments. Achieving a decent retirement income will continue to be a major economic issue and social policy challenge regardless of whether the Scottish electorate votes in favour of independence on 18 September 2014. The debate over Scottish independence is therefore not the only major consideration for pensions stakeholders but it does add complexity in the context of wider reforms and proposals being driven by the UK and EU.

Negotiations between the Scottish and UK Governments are only likely to occur in the event of a 'yes' vote but both Governments need to prepare for these in advance. Further work should be undertaken to quantify existing public sector pension liabilities and state pension commitments so that this information is available for the commencement of any treaty negotiations. In developing and implementing transitional arrangements due consideration should also be given to pensions rights of individuals which have been built up over their working lives and these should be sufficiently robust to ensure that those who are retired continue to receive their pensions uninterrupted. There would be complex technical issues to resolve for cross-border defined benefit and hybrid schemes and this is an area where direct engagement by both Governments with the pensions industry and the EU would probably be essential if the financial impact of the EU's solvency rules on these schemes and their sponsoring employers is to be minimised.