EXPLANATORY MEMORANDUM TO

THE OCCUPATIONAL PENSION SCHEMES (CONTRACTING-OUT AND MODIFICATION OF SCHEMES) (AMENDMENT) REGULATIONS (NORTHERN IRELAND) 2012

S.R. 2012 No. 125

1. Introduction

1.1 This Explanatory Memorandum has been prepared by the Department for Social Development to accompany the Statutory Rule (details above) which is laid before the Northern Ireland Assembly.

1.2 The Statutory Rule is made under sections 12(3) and 177(4) of the Pension Schemes (Northern Ireland) Act 1993 and Articles 68(2)(e) and 166(3) of the Pensions (Northern Ireland) Order 1995 and is subject to the negative resolution procedure.

2. Purpose

2.1 These Regulations makes technical amendments to existing Regulations to –

- implement the Government Actuary's recommendation to increase from 4 per cent to 4·75 per cent the amount of fixed rate revaluation of guaranteed minimum pension for early leavers;

- allow trustees of formerly contracted-out defined contribution occupational pension schemes to change their scheme rules as a result of the abolition of "protected rights". Protected rights are pension rights derived from the State's contribution to the pension scheme through lower rate National Insurance contributions and payments from HMRC etc. Protected rights are subject to special rules and have to be kept separate from other pension rights under the scheme.

3. Background

3.1 *Fixed rate revaluation percentage*. A guaranteed minimum pension is a pension which has been built up in a contracted-out, defined benefit, workplace pension scheme between 1978 and 1997. If a member of such a pension scheme leaves that employment before the age the guaranteed minimum pension can be taken, the scheme has a statutory duty (under section 12 of the Pension Schemes (Northern Ireland) Act 1993) to revalue the amount of guaranteed minimum pension which is due to the member until it is payable.

3.2 Presently, where a person's pensionable service ends on or after 6th April 2007, the percentage used for fixed rate revaluation purposes is 4 per cent. These Regulations prescribe that schemes which use the fixed rate method of revaluation will have to adopt the figure of 4·75 per cent for individuals who leave the sponsor's employment on or after 6th April 2012.

3.3 *Modification of scheme rules*. The Pensions Act (Northern Ireland) 2008 provides for the abolition of contracting-out for defined contribution pension schemes – this takes effect from 6th April 2012. As a result of the abolition of defined contribution contracting-out, all rules and references to "protected rights" in pensions-related legislation will either be repealed, or where appropriate, amended. In contracted-out defined contribution schemes, protected rights are either the rights to money purchase benefits under the scheme, or where the scheme rules specify the amount of an individual's pension fund derived from the National Insurance rebate, its investment return, and any tax relief on the rebate. On abolition, protected rights will cease to exist; they will become ordinary money purchase scheme benefits.

3.4 These Regulations provide trustees with the ability to modify their scheme rules to remove protected rights requirements which apply to accrued rights. They also prescribe the removal of scheme rules relating to protected rights which are no longer required as a result of the abolition of contracting-out on a defined contribution basis coming into force on 6th April 2012. The power provided is time limited; trustees will have until 5th April 2018 to make amendments to their rules.

4. Consultation

4.1 There is no requirement to consult on these Regulations as they make in relation to Northern Ireland only provision corresponding to provision contained in regulations made by the Secretary of State for Work and Pensions in relation to Great Britain.

5. Equality Impact

5.1 In accordance with its duty under section 75 of the Northern Ireland Act 1998, the Department has conducted a screening exercise on the legislative proposals for these Regulations. As the amendments are largely technical in nature, the proposals would have little implication for any of the section 75 categories. In light of this, the Department has concluded that the proposals would not have significant implications for equality of opportunity and considers that an Equality Impact Assessment is not necessary.

6. Regulatory Impact

6.1 The proposal to change the amount of the fixed rate revaluation of guaranteed minimum pension for early leavers does not require a Regulatory Impact Assessment as it amends an existing regulatory regime and has no new impact on costs on business, charities or voluntary bodies. An assessment of the impact of the proposal to allow trustees to modify their scheme rules is included in the Regulatory Impact Assessment which accompanied the Rules to abolish contracting-out on a defined contribution basis. A copy of that Regulatory Impact Assessment is attached as an annex to this Explanatory Memorandum.

7. Financial Implications

7.1 None for the Department.

8. Section 24 of the Northern Ireland Act 1998

8.1 The Department has considered section 24 of the Northern Ireland Act 1998 and is satisfied that these Regulations –

(a) are not incompatible with any of the Convention rights,

(b) are not incompatible with Community law,

(c) do not discriminate against a person or class of person on the ground of religious belief or political opinion, and

(d) do not modify an enactment in breach of section 7 of the Northern Ireland Act 1998.

9. EU Implications

9.1 Not applicable.

10. Parity or Replicatory Measure

10.1 The corresponding Great Britain Regulations are the Occupational Pension Schemes (Contracting-out and Modification of Schemes) (Amendment) Regulations 2012 (S.I. 2012/542) which come into force on 6th April 2012. Parity of timing and substance is an integral part of the maintenance of single systems of social security, child support and pensions provided for in section 87 of the Northern Ireland Act 1998.

Annex

REGULATORY IMPACT ASSESSMENT

ABOLITION OF CONTRACTING-OUT FOR DEFINED CONTRIBUTION PENSION SCHEMES

The costs and savings outlined in this Regulatory Impact Assessment are calculated on a United Kingdom-wide basis.

BACKGROUND

The State pension system

1. Entitlement to the Basic State Pension is dependent on payment of National Insurance contributions (NICs). The Basic State Pension is a flat rate pension and full entitlement is gained by paying 30 qualifying years of National Insurance contributions.

2. There is also an earnings-related component of state pension provision, known as the State Second Pension (S2P) (which replaced State Earnings Related Pension Scheme (SERPS) in 2002). Individuals build entitlement to this earnings-related component by paying the full rate of National Insurance contributions. The individual's entitlement is calculated on the basis of average lifetime earnings revalued to take account of increases in national average earnings.

Contracting-out of the earnings-related element of state pension from 1978

3. The concept of contracting-out (leaving the earnings-related element of the state pension system) under SERPS was that in return for providing pension benefits broadly equivalent to the benefits payable under SERPS, lower National Insurance contributions were payable by the employer and employee.

4. Initially, (from 1978) an individual could only be contracted-out if they were a member of a defined benefit (DB) occupational pension scheme. However, from 1988, defined contribution (DC) occupational pension schemes that satisfied various conditions were permitted to contract members out of the earnings-related state pension. Members of occupational defined contribution schemes and their employers received a rebate on their National Insurance contributions which had to be paid into the member's pension fund.

5. Since 1988, individual employees have been permitted to contract-out of SERPS by contributing to a personal pension scheme and from 2002 into a stakeholder pension scheme, provided that various conditions were met. Members of personal pension schemes pay full rate National Insurance but at the end of the tax year, a rebate is paid into the member's personal pension scheme.

6. Contracting-out is designed to be actuarially neutral, so the amount of S2P for a contracted-in individual is expected to be equivalent to the private pension that would be derived from the rebate for a contracted-out individual. The individual should therefore be neutral between being contracted-in and being contracted-out.

Abolition of contracting-out through defined contribution pensions

7. DC contracting-out commenced in 1988[1]. This was during a sustained period of strong equity market returns, and at a time when free markets and investing were extremely fashionable – the real return on equity investments between 1981 and 1986 was in excess of 20 per cent. per annum.

8. Since it was introduced, the number of members who are contracted-out has steadily declined from a peak of 4.7m in 1992 to 1.9m in 2008/09, despite growth in DC pensions resulting from the decline of DB pensions.

9. Over the last decade many pension providers have either contracted members back-in, written to members to inform them they will be contracted-back in unless they opt-out, or suggested members should contract back-in. This is because many providers were concerned that members could expect to be better off financially from being contracted-in than being contracted out[2], and considered that there could be future accusations that providers were not fulfilling a perceived duty of care - and possibly be liable for financial sanction - if they did not take steps to at least inform members of this. Some providers felt they should go further.

10. In 2005, an independent Pensions Commission, chaired by Lord Turner, recommended the abolition of contracting-out on a DC basis. The Commission's view was that the contracting-out/contracting-in choice added complexity to the UK pension system and was poorly understood. Its application to personal pensions helped generate the pensions mis-selling problems of the 1990s. The Commission's recommendation was accepted and during the passage of the Pensions Act 2007 there was widespread support in Parliament for abolition. The Pensions Act (Northern Ireland) 2008 made corresponding provision for abolition. In March 2010, the Westminster Government announced that abolition would be on 6 April 2012, and that date was confirmed by the present Westminster Government.

11. The rationale for change and the options for reform are described in detail in the regulatory impact assessment for the Pensions Act (Northern Ireland) 2008. That assessment also covered the wider pension reform agenda including work place pension reform and reducing the number of qualifying years for receipt of basic state pension. The impact assessment is available from: http://www.dsdni.gov.uk/print/ria-pensions-bill-nov07.pdf

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1 It was introduced in legislation in the Social Security (Northern Ireland) Order 1986.

2 Particularly as since the late 1990s there has been a cap on rebate rates, which is currently set at age 44, such that for people above this age being contracted-in is a better than neutral outcome.

12. The collective term for the National Insurance rebate, associated tax relief and investment return that accrued whilst contracted-out is ‘protected rights’. Under the current DC contracting-out system, there are special rules relating to protected rights which abolition will remove. These rules include:

- restrictions on the type of scheme in which protected rights can be invested or to which they can be transferred;
- a requirement to purchase a unisex annuity; and
- a requirement to make provision for a survivor benefit where the member is married or in a civil partnership at the point of annuitisation.

13. Abolition of contracting-out on a DC basis will:

- provide greater clarity for individuals in their savings decisions and more flexibility in how they shape their retirement income. There will be only one set of rules covering the whole of a person’s pension savings and they will be able to choose an annuity most suited to their circumstances;
- remove the difficult judgment that individuals currently have to make about whether they would be better off contracted-in or contracted-out of the State Second Pension;
- allow individuals to make more informed decisions about their additional pension saving options by building on a clear foundation from the State;
- will remove some of the administrative burdens placed on schemes by having to adhere to different rules concerning protected rights.

<u>Costs and benefits: impacts on affected groups</u>

14. For summary purposes, the table below breaks down the present value of the costs and benefits by employers, individuals, schemes and government. Further description of these costs and benefits is provided in the sections below:

Table 1: Present value of monetised policy costs and benefits 2012-2060

	Costs		**Benefits**	
	£bn, pv terms	**Reason**	**£bn, pv terms**	**Reason**
Employers	1	Increased National Insurance contributions	1	No longer required to pay rebate into pension scheme
Individuals	50	Increased National Insurance contributions/reduction in private pension assets	50	Receipt of State Second Pension/reduction in individuals' private pension contributions
Schemes/industry	-	-	0.13	Administrative saving from no longer having to track contracted out DC rights
Government	-	-	0.015	Administrative saving from no longer having to administer DC contracting out.
Total	**51**	-	**51.14**	-

Impact on individuals, employers and the financial services sector

15. Under DC contracting-out, the employer and individual receive a rebate of National Insurance contributions which are then paid into the individual's private pension fund. In return for this rebate the individual foregoes building entitlement to the S2P, a state-provided, earnings-related pension. Rebate rates are set in an actuarially neutral fashion, such that they cover the expected cost of providing the S2P through the individual's private pension. When taking their pension income, individuals are required to adhere to certain rules about how they shape their rebate-derived pension income (e.g. they must purchase an inflation-linked annuity, they must make a provision for a survivor). The individual currently has a choice over whether they wish to be contracted out in this way or not.

16. The benefits of this system to the individual are that they receive additional money in their private pension fund today in lieu of a stream of payments from the State many years into the future. However, a consequence of the deal is that they bear the risk of their private pension underperforming, and providing less

than the state scheme would provide. Although in expectation[3], individuals should be left unaffected by whether they are contracted in or out, in practice, there will be a wide range of outcomes from having contracted out – compared to being contracted-in into the S2P, some people will do better, some will do worse and some will be neutral. It is not possible to monetise the value of this choice to the individual – its value is purely down to individual preference over whether to be contracted in or out. Some people will prefer having the money in their pension today and will be happy to bear the risk of their fund performing badly; others will prefer to give up the money today in return for the greater certainty of the State scheme.

17. To the extent that this choice is removed once DC contracting-out is abolished, there is a restriction on individual choice relative to the current system. However, it is believed that the benefits to individuals are greater for a number of reasons, some of which were also articulated by Lord Turner's Pensions Commission[4], an independent commission set up in December 2002, with the remit of keeping under review the adequacy of private pension saving in the UK, and advising on appropriate policy changes:

    - The choice over whether to contract out or not has added complexity to the UK pension system and is poorly understood. Its application to personal pensions helped generate the pensions mis-selling problems of the 1990s.
    - By contracting back into the S2P, individuals pass the risk of uncertainty in their DC pension income onto the State, which provides them with a more certain, earnings related pension in retirement.
    - Having a more certain component of state pension in their overall pension income could aid the saving decision for individuals. By receiving a greater fraction of their pension income through the State, the individual now needs to make lower levels of private pension contributions in order to reach a given level of pension income.

18. For these reasons, Parliament, when passing the Pensions Act 2007, believed the restriction on individual choice brought about by the ending of DC contracting-out was justifiable and indeed beneficial to individuals. The fact that the numbers contracting out in a DC pension has been in steady decline from a peak of 4.7 million contracted-out DC arrangements in 1992 to 1.9 million in 2008/09[5], suggests that individuals place greater value on the certainty of the S2P in comparison to the contracted-out rebate.

19. With the abolition of DC contracting-out already having been legislated for by the Pensions Act (Northern Ireland) 2008, many individuals may not have made any further decisions on whether to contract in or out – knowledge that the choice is being removed from 2012, coupled with inertia, means some people will simply not take any action either way.

20. The regulatory impact assessment for the Pensions Act (Northern Ireland) 2008 estimated that the rebate for DC schemes (both personal pension and

3 Given the actuarial neutrality of rebate rates.
4 'A New Pension Settlement for the Twenty-First Century: The Second Report of the Pensions Commission', 2005.
5 Source: Second Tier Pension Provision statistics.

occupational DC pension schemes) amounted to £3.5 billion (in cash terms) in 2003/04. That figure is now forecast by HMRC to be around £2.6 billion (in cash terms) by 2011/12; the main reason for it being lower is that fewer people are now contracted-out.

21. The contracting-out rebate is set by the Secretary of State for Work and Pensions, based on calculations by the Government Actuary, to be actuarially neutral, and is based on the expected cost, given prudent assumptions on investment returns, of providing a private pension equivalent to the S2P foregone. The actuarial neutrality of rebate rates[6] ensures that the individual is, in expected value terms, unaffected by whether they are contracted in or contracted out. So abolishing DC contracting-out and contracting the individual back in to the S2P means that the expected impact on the individual is neutral in financial terms. This is shown in table 1, which contains the costs and benefits of the policy to individuals – the present value of increased National Insurance contributions over the period to 2060 is exactly equal to the increased S2P expenditure which goes to individuals. Costs appear greater than benefits in the early years because National Insurance rises in the short term, but the benefit of additional S2P entitlement does not begin until retirement. However, in the long run, the effect will be neutral for the individual.

22. In effect, abolishing contracting-out means that individuals simply exchange part of their private pension for some additional state pension. The overall cost for individuals of making pension provision remains the same – the policy effectively moves their contributions from their private pension into the S2P. Therefore removal of the rebate will result in a lower private pension but that difference will be made up by a similar increase in the S2P in the long run.

23. The main non-monetised benefit for individuals is having greater control over their private pension fund, through no longer having to abide by the protected rights rules, which govern what they must do with the contracted-out element of their pension fund. Individuals will be able to make decumulation decisions that suit them best, without prescription from the State. Individuals will also face a simpler state pension system, with the complexity around the contracting-in/out decision removed.

24. For employers sponsoring contracted-out occupational DC schemes, there will be an increase in National Insurance contributions of 1.4 percentage points on employee earnings between the Lower Earnings Limit and the Upper Accrual Point. However, the current legislation states that the employer must pay this amount into the pension scheme on the member's behalf. Removal of the rebate also means removal of the requirement to make that contribution to the scheme so again the effect on employers will be cost neutral, assuming that they no longer make the minimum payment. Furthermore, very little of the total rebate goes to sponsors of contracted-out occupational DC schemes - just 8 per cent of active contracted-out DC membership is in occupational schemes[7] - so the vast

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6 Since the late 1990s, rebate rates, which are age specific, have been capped below the actuarially neutral level for some age groups. Rates have been capped for people above the age of 44, such that for this group, being contracted into the State Second Pension represents a better than neutral outcome.

7 Source: Second Tier Pension Provision statistics.

majority of the impact is on individuals with personal pensions rather than employers.

25. The figures under the costs and benefits in Table 1 above also include these off-setting National Insurance and minimum payment figures respectively. These, like the figures for individuals discussed in paragraph 18 above, are based on internal DWP forecasts. These are based on the same methodology as the 2006 forecasts that accompanied the production of the Pensions Act (Northern Ireland) 2008 regulatory impact assessment, but updated for more recent trends in DC contracted-out membership.

26. To capture the full effects of this policy change the impact assessment covers the period 2012 to 2060 - because it is only over such a long period that the benefits to individuals of increased S2P payments will be realised. Over the period 2012-2060, the average annual cost of the DC rebate in the counterfactual[8] is estimated to be £2.3 billion (2010/11 prices). The present value of the annual cash flows to 2060 is £51.0 billion (2010/11 prices). This is the same for both the cost of the increased National Insurance contributions for employers and individuals, and the benefit of the ending of the minimum payment for employers, along with the increased S2P for individuals. In aggregate, the impact is neutral.

27. An indirect impact of the policy is that it reduces the amount of financial assets in the private pension system. Scheme administrators and fund managers levy charges on funds under management and will therefore see a reduction in income, following the withdrawal of the contracting-out rebate from individuals, which could build up to a significant amount over time. This loss should be off-set to a small extent by the small gains from the reduced administration costs discussed in paragraph 35.

28. When an individual, or group of individuals, cease to be contracted out, the rebate will simply stop being paid into their pension fund – it is not the case that a provider would have to close down a particular contracted-out product. Despite urging members to contract back into the S2P and no longer actively market contracting-out, anecdotal evidence suggests providers continue to offer the option to contract out on the grounds of customer service.

29. To put the scale of DC contracting-out into perspective, the annual DC contracted-out rebate is around £2.6bn, compared to total assets of DC schemes of £470bn - £965bn[9] which means the contracted-out rebate is worth 0.3 - 0.6 per cent. of total DC assets.

30. ***Lack of evidence about profit levels:*** The pensions industry may be able to make a profit from managing this additional £2.6bn per year. However, it is not known what amount of profit the industry would make from this as despite DWP consulting with industry, industry were unable to provide estimate of their profit margin. This is because the information is commercially sensitive, and it is also difficult to isolate and attribute profit arising from contracted-out funds alone, as

8 In order to assess the impact of ending DC contracting-out, a counterfactual is required – in this case, the current system of DC contracting-out. The impact of ending DC contracting-out is then measured in relation to what would have happened if it had continued in its current form.

9 ABI Money in funded pensions, 2010.

the funds are processed and managed alongside employer and employee pension contributions as part of the overall pension fund. That the cost will be small is reinforced by the observation that as well as some providers deciding to contract members back in, one major provider also exited the contracting-out market for new members in recent years, further supporting the conclusion that profits from providing contracted-out benefits are small.

31. ***Industry supports abolition***: That the cost will be minimal is further supported by the response to DWP's consultation[10] which raised the issue of the impact of abolition on the insurance industry and other firms managing contracted-out pension funds. A number of pension providers commented on abolition but none of the respondents commented directly on the loss of funds under management. As is clear from the industry views during the consultation (a selection of which are shown below), there was a lack of concern over the abolition of DC contracting-out.

The National Association of Pension Funds:

"We are pleased that the Government has recognised the additional complexity contracting out poses to schemes and that it can act as a barrier to saving. We therefore welcome the Government decision to abolish contracting out for defined contribution schemes from 2012."

Scottish Widows:

"While the abolition of money purchase contracting out removes a source of funded private pension saving it (abolition) is, on balance, a desirable step. The current structure and level of contracting out rebates are such that Scottish Widows, and many other pension providers, have taken action to urge individuals to contract back in to S2P. As such the abolition of money purchase contracting out largely reflects what is already happening."

HBOS (another large provider):

"HBOS supports the proposal to abolish contracting out into defined contribution schemes. From consumers' perspective the rebate rate is now either neutral or low and it will generally be either to their advantage to contract back in or very hard to make the decision."

Other key industry representative bodies, the Association of British Insurers and the Confederation of British Industry did not indicate any concerns in relation to either abolition or loss of profits in their responses.

32. The impact on scheme administrators and fund managers is considered to be second order because the reduction in income comes about from the fact that individuals receive less money to go into their private pension fund. The direct

10 Security in Retirement: towards a new pensions system May 2006: http://www.dwp.gov.uk/policy/pensions%2Dreform/security%2Din%2Dretirement/

impact therefore falls on individuals with the impact on scheme administrators and fund managers being second order.

Impact on occupational and personal pension schemes

33. Following abolition, pension schemes will no longer be obliged to track DC contracted-out rights separately from other pension rights. This means that some administrative burdens will be removed from those schemes. When the Pensions Act (Northern Ireland) 2008 regulatory impact assessment was produced, it was not possible to assess how much of these administrative costs relate to the separate tracking of contracted-out rights and, when asked, scheme providers were themselves unable to quantify these costs. DWP recently asked key pensions industry stakeholders if they are now able to quantify the costs of contracting-out and again they have responded in the negative.

34. However, PricewaterhouseCoopers (PwC), in a 2006 study[11], identified the cost of regulation relating to a large number of different policy areas, private pensions amongst them. PwC provided DWP with a detailed set of information of the costs of regulation that was identified as being relevant for private pensions, including those relating to contracting-out. The assessment of the administrative savings from this policy considered only those provisions which are relevant to contracting-out on a defined contribution basis. Within particular sets of regulations the assessment takes account of only those measures which relate to disclosure of information requirements. The estimate covers the total costs (in £ millions) associated with individual provisions and the total savings from their abolition. Some apportioning was necessary. This was done on the basis of current active membership: contracted-out DB is around 7 million and occupational defined contribution is about 400,000[12] so approximately a 17:1 ratio. The PwC figures were estimated in 2006, since when there has been a 20 per cent decline in DC contracted-out membership; this assessment takes account of this.

35. Altogether the savings from the 2012 changes totals around £5.3 million per annum in constant prices[13] (the original 2006 figures have been increased in line with the retail price index to take account of inflation since 2006). In the absence of any estimates from the private pensions industry, this has been assumed to be the annual saving to industry from abolition of DC contracting-out. Over the period to 2012-2060, which is the period under consideration in this impact assessment, the present value of these annual administrative savings is estimated to be £130 million (2010/11 prices).

36. There is a one-off cost of converting from a contracted-out to a contracted-in scheme. This includes: changes to the IT systems of pension providers; communications with individual members informing them of the move to contracted-in status and the implications of this; and, in the case of occupational

11 'Administrative Burdens Measurement Exercise', PwC, 2006. Available to download from: http://www.dwp.gov.uk/docs/adminburdens2.pdf

12 Of the 1.9 million DC contracted-out arrangements, 400,000 are in occupational DC schemes, with the remainder in Personal Pensions.

13 The cost of these regulations is £5.1 million today. A further two years of inflation (RPI is estimated by the Office for Budget Responsibility to be 3.6 per cent. in 2011 and 3.0 per cent. in 2012) means that these costs will be worth £5.3 million per annum in constant prices on the abolition of DC contracting-out in 2012.

schemes, changes to payroll systems to account for the increase in National Insurance contributions following abolition of contracting-out. DWP asked industry stakeholders to provide information on these costs and has received responses from The National Association of Pension Funds (NAPF) and the Association of British Insurers (ABI), which have asked their members for this information. Based on these discussions, DWP has been informed that a per-member cost of £3 in today's prices is a reasonable estimate of these one-off costs. Allowing for a further two years of inflation increases at 3.6 per cent in 2011 and 3.0 per cent in 2012[14] bring this to £3.20 on abolition in 2012. Based on there currently being 1.9 million contracted-out DC arrangements (see paragraph 15), the estimated one-off cost of converting to contracted-in status in 2012 is £6.1 million (£3.20*1.9 million) in cash terms. In today's prices (2010/11) this equates to a one-off cost of £5.8 million.

Impact on the Exchequer

37. The Exchequer will receive increased National Insurance (NI) revenue through not paying the NI rebates but will have to pay higher S2P to those who have been put back into the S2P. In the long term, increased benefit spending on S2P will offset any early savings and the effect will be broadly neutral, with the main impact being one of timing; expenditure today being shifted into the future.

38. There is a small administrative saving to government from no longer having to administer DC contracting-out. Estimated savings are only available up to 2019/20 and are around £2 million per annum, on average (2010/11 prices). The present value of these savings over this period is around £15 million.

Gender impacts

39. In theory there could be a negative impact on women once the requirement to purchase a unisex annuity with protected rights is removed, since women should benefit more from a unisex annuity rate than a gender-specific annuity. This is because a unisex annuity rate will be based on both male and female rates, whereas under a gender-specific regime, females would receive a lower rate owing to their longer life expectancy[15]. This is a risk, but it is believed that the benefits of getting rid of the protected rights rules outweigh this risk. Furthermore, the unisex annuity market is small – the Pensions Policy Institute estimate[16] that only 3 per cent of the annuity market is comprised of unisex annuities. Any adverse impact will therefore be limited to a small proportion of annuity purchases.

40. By the same token, men who are currently required to purchase a unisex annuity will benefit from the protected rights rules being removed. They will be able to

14 Source: Office for Budget Responsibility.

15 On 1st March 2011, the European Court of Justice ruled that the use of gender as a risk factor in insurance contracts constituted discrimination. This will have implications for pensions annuity contracts in the future– it is expected that males and females of the same age will face annuity rates closer to the current female rates as a result of this ruling. The full implications of this ruling will become clear in the coming months.

16 'An analysis of unisex annuity rates', Pensions Policy Institute, 2004. Available to download from: http://www.pensionspolicyinstitute.org.uk/uploadeddocuments/EOC_PPI_Unisex_Annuity_Report_June04.pdf purchase a gender-specific annuity, which for them, will provide a superior rate compared to a unisex annuity.

Consequential change to secondary legislation as a result of abolition of contracting-out on a defined contribution basis

Background

41. The changes to secondary legislation are essential in order to fully implement the primary legislative changes already agreed by government for abolition. The secondary changes do not introduce new policy - instead they make changes that are consequential on abolition of contracting-out on a DC basis. They remove rules and references that relate to DC contracting out from 6 April 2012, and introduce other provisions that will provide for a transitional period until 2015. A consequential change relates to transfers from contracted-out salary-related schemes (DB schemes) to non–contracted-out schemes.

42. Contracting-out is not being abolished for DB schemes. Legislation currently limits transfers only to other contracted-out schemes – from contracted-out DB schemes to contracted-out DC schemes or vice versa. This is because special rules apply to contracted-out benefits, both in accrual and in payment. Currently, out of a total contracted-out DB membership of about 8 million (active and deferred members), there are about 46,000 transfers per annum to contracted-out DC schemes[17].

43. Following a public consultation, and consideration of the representations from the private pensions industry, the intention is to introduce a more flexible approach to allow individual members the freedom to transfer from a contracted-out DB scheme to a non-contracted-out scheme following abolition. This will give individuals greater freedom and flexibility in shaping their retirement income to best suit their needs.

Impact on individuals and schemes

44. The provisions will provide more choice and flexibility for scheme members. They will, for example, be able to consolidate a number of small pension pots for a coherent retirement income. Members who transfer will no longer be required to make provision for a surviving spouse or civil partner but will retain the option to choose a joint life annuity. This could benefit members for whom the survivor benefit requirement might not be appropriate – for example if the spouse or partner has sufficient or better pension provision of their own. In some cases couples might prefer to have a higher starting pension during their early and more active years of retirement.

45. Scheme members will be required by law to consent in writing to a transfer and to acknowledge that they understand the implications of transferring, including that there will be no automatic provision for a survivor pension. They will be signposted to the relevant information available on annuity choice.

17 Source: HMRC.

46. Schemes already have systems in place for transfers to non-contracted-out overseas arrangements. This additional flexibility will not impose any costs or savings on schemes.

Impact on survivors and equality impacts

47. Transferring from a contracted-out DB scheme will remove the requirement to provide for a 50 per cent survivor pension for a spouse or civil partner. The survivor benefit rule reflects the fact that, had the scheme member not been contracted-out, a survivor would inherit 50 per cent of their spouse/civil partner's additional state pension. The main impact of loss of the survivor benefit on transfer could be on widow/ers who have a broken work pattern and who have not built up state or private pension provision of their own. The risk is that a scheme member could choose a single-life annuity, leaving a survivor with little or no pension from the private pension scheme or from the additional state pension in respect of the years of contracting-out. According to data from the Association of British Insurers[18], around three-quarters of annuities are purchased with funds of less than £30,000, and 60 per cent of annuities are purchased with funds of less than £20,000. These represent total fund sizes and indicate that the average protected rights fund, which will be a sub-set of the total fund size, will be smaller. As an illustration, based on current annuity rates[19], a protected rights fund of £30,000 would buy around £17 a week in survivor benefit – so the impact should be limited.

48. A number of factors will mitigate the impact on survivors, who are for the most part women. Other provisions of the overall pensions reform package will result in women having better pension provision of their own and therefore reduce reliance on the survivor pension. For example, the state pension reform package will deliver a much fairer deal for women and carers by recognising working and caring contributions in the same way so more women will qualify for full state pension.

49. Increasing female participation in the labour force has led to more women having their own pension provision and, therefore, they are less reliant on a survivor benefit.[20] There has been significant growth in female labour market participation and a consequential growth in female pension provision. Female employment rates have gone up from 56 per cent in 1971 to just under 70 per cent today. Female pension provision has also increased over time, particularly amongst part time workers; in 1983 13 per cent of female part time workers were members of their employer's pension scheme compared to just under 40 per cent today; for full time female workers the membership has increased from around 55 per cent of all female workers in 1983 to just under 60 per cent today.

18 ABI data on quarterly annuity sales by fund size is available from: http://www.abi.org.uk
19 Source: FSA annuity tables, December 2010. Based on a 65 year old male purchasing a level annuity with a 50 per cent. survivor benefit.
20 The source for these figures is the ONS Pension Trends website:
http://www.ons.gov.uk/ons/about-ons/our-statistics/publications/pension-trends/index.html

50. Furthermore, as stated in paragraph 44 above, the member will have a choice over annuity provision - in some cases it will be appropriate to make provision for a partner but in other cases the overall household income could be higher by the purchase of a single life annuity. The policy allows for appropriate personal financial decisions to be made rather than those imposed by the state.

51. There is no evidence to suggest that any of the proposals in this Impact Assessment would have any impacts on other groups.

IMPACT TESTS

Competition

1. There are no implications for competition policy.

Small firms

2. There are no specific impacts on small firms. Although DB schemes are more common in large companies they are also provided by a number of small companies.

Legal aid

3. There are no implications for legal aid.

Sustainable development, carbon assessment, other environmental impact

4. There are no implications.

Health

5. There are no implications for health.

Human rights

6. There are no implications for human rights.

Rural proofing

7. There are no implications for policy on rural issues.

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed for the Department for Social Development

Anne McCleary

Anne McCleary
7 March 2012

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