

<b>Title:</b> The Occupational Pension Schemes (Power to Amend Schemes to Reflect Abolition of Contracting-out) Regulations 2015  <b>Lead department or agency:</b> DWP  <b>Other departments or agencies:</b>	<b>Impact Assessment (IA)</b>				
	<b>Date:</b> 04 March 2015				
	<b>Stage:</b> Final				
	<b>Source of intervention:</b> Domestic				
	<b>Type of measure:</b> Secondary Legislation				
	<b>Contact for enquiries:</b> Lillian Coulson, 0207 499 7232, Lillian.Coulson@dwp.gsi.gov.uk				
<b>Summary: Intervention and Options</b>					
<b>RPC Opinion:</b> Not in scope					

**What is the problem under consideration? Why is government intervention necessary?** The new State Pension will be a simple, flat-rate contributory pension. Reforming the system into a single payment will close the additional State Pension (AP). This, in turn, will end the system which enables sponsors of defined benefit (DB) occupational pension schemes to contract members out of AP. Under the current system employer and employee pay a lower rate of National Insurance contributions and in return schemes are required to provide a pension that meets a minimum standard. The abolition of contracting-out will result in the loss of the NI rebate for relevant employers. Some employers can recover this additional cost but others will be prevented from making such changes by their scheme rules and, or, the requirement for trustee consent to make changes.

**What are the policy objectives and the intended effects?** The Government intends to give employers sponsoring private sector schemes limited powers, to change pension scheme rules without trustees' consent. The policy objective for the employer amendment power is to ensure that the sustainability of DB schemes is not undermined by minimising the impact of the loss of the NI rebate on employers. Employers will be able to amend scheme rules without trustee approval, reducing scheme costs to reflect the increased employer National Insurance contributions when contracting-out ends. The regulations set out the detail as to how employers may use the amending power. Any scheme changes must be certified by an actuary as recovering no more than the loss of the rebate.

**What policy options have been considered, including any alternatives to regulation? (further details in Evidence Base)** Two options were considered (1) do nothing (i.e. end contracting-out for DB schemes with no mitigating employer amendment power) and (2) provide an amending power for employers from April 2016 which would give employers three options to mitigate the loss of the NI rebate by:

- increasing the employee contributions of the relevant members;
- altering the future accrual of benefits for or in respect of them;
- or a combination of the above.

Do nothing is not a realistic option given the aim of not undermining the sustainability of DB schemes. Employers have asked for an option to mitigate the impact of the loss of the NI rebate. In the absence of an amending power, employers would have to bear the cost of the loss of the NI rebate while maintaining the same occupational scheme benefits. Some private sector employers are limited in their ability to modify scheme structure by legislation or by scheme rules. In many cases scheme rules can only be changed by the trustees or with trustees' consent. As changes resulting from the end of contracting out are likely to be detrimental to members' workplace pension income, it is possible that trustees may not consent to them. Without the amending power some employers may be more likely to close their scheme.

Option 2 ensures that the vast majority of employers (as above) have an option available to them to mitigate the loss of the NI rebate. A non-regulatory alternative has not been considered because there is a legal framework for pensions which has to be altered to deliver the mitigating options. The mitigating options could not be achieved through non legislative means because some employers are limited in their ability to amend the scheme rules themselves. In many cases, scheme rules can only be changed by trustees or with trustees' consent. As changes in response to the end of contracting-out are likely to reduce members' pension income or increase their contributions, it is possible that trustees may not consent to them.

<b>Will the policy be reviewed?</b> There is no plan to do a policy review. This is a time limited policy, which is designed to help employers					
<b>If applicable, set review date:</b> Month/Year					
Does implementation go beyond minimum EU requirements?				N/A	
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.		<b>Micro</b> Yes	<b>&lt; 20</b> Yes	<b>Small</b> Yes	<b>Medium</b> Yes
What is the CO <sub>2</sub> equivalent change in greenhouse gas emissions? (Million tonnes CO <sub>2</sub> equivalent)				<b>Traded:</b> N/A	<b>Non-traded:</b> N/A

***I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.***

Signed by the responsible Minister:  Date: 12/02/15

## Background

### The State pension system currently

1. There are two parts to the current state pension. The basic State Pension is a flat rate pension and full entitlement is gained by building up 30 qualifying years of National Insurance contributions (NICs) or credits. There is also an earnings-related component of state pension provision known as the additional state pension (AP) – the main component of AP is the State Second Pension (S2P) (formerly State Earnings Related Pension Scheme (SERPS) before 2002).

### Abolition of contracting-out through DB schemes

2. Employers who sponsor a defined benefit (DB) schemes that meets the requirements pay lower NI and so do members. With the introduction of a new State Pension, there will be no AP. As a consequence, contracting-out AP will come to an end for DB schemes.
3. From 6 April 2016, employees who are contracted-out when the new State Pension is introduced will be automatically brought back into the full state scheme. Both employers and employees will stop paying a lower rate of NI and instead pay the standard rate of NI as all other employers and employees. The impact of the abolition of contracting-out on employee NICs is considered on pages 15-17 of the updated Impact Assessment document published in July 2014. More detailed information, including impact on employer NICs is available in Chapter 5 of the Impact Assessment which accompanied Royal Assent of the Pensions Act 2014.

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/332996/single-tier-pension-impact-assessment-update-july-2014.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/332996/single-tier-pension-impact-assessment-update-july-2014.pdf)

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/311316/pensions-act-ia-annex-a-single-tier-state-pension.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/311316/pensions-act-ia-annex-a-single-tier-state-pension.pdf)

### Employer amendment power

4. Many organisations who responded to the Government's consultation on state pension reform, '*A State Pension for the 21st Century*' (the Green Paper), told us about the significant implications that ending contracting-out for DB schemes would have for sponsoring employers, schemes and employees. The Pensions Act 2014 contains provisions to grant sponsoring employers an amending power by allowing them to alter the terms of their DB schemes without trustee consent to recoup the cost of the additional NICs which will result from the end of contracting-out.
5. The Government consulted on two sets of draft regulations from 8 May to 2 July 2014 that will support the abolition of DB contracting-out schemes:
  - The Occupational Pension Schemes (Power to Amend Schemes to Reflect Abolition of Contracting-out) Regulations; and
  - The Occupational Pension Schemes (Schemes that were Contracted-out) Regulations.
6. The draft Occupational Pension Schemes (Power to Amend Schemes to Reflect Abolition of Contracting-out) Regulations 2015 set out the detail of how the employer amendment power may be used and in particular, the calculations that actuaries will be required to make, how they should make them and what certification will be required. We have addressed

respondents concerns by amending the draft regulations. We have summarised the feedback in the Government response to the consultation, which is being published alongside this Impact Assessment which focuses on the costs and benefits associated with the provision of this amending power for employers.

<https://www.gov.uk/government/consultations/occupational-pension-schemes-abolition-of-defined-benefit-contracting-out>

## **Rationale for intervention**

7. The rationale for intervention is to ensure that the sustainability of DB schemes is not undermined, by giving employers a way if needed to ease the burdens on employers who will no longer receive the NI rebate.

## **Policy Objective**

8. The policy objective for an amending power is to ensure that the sustainability of DB schemes is not undermined by giving employers the option to offset the loss of the NI rebate. It gives employers, if all else fails one way to amend their scheme rules to reflect the loss of NI rebate.

## **Description of options considered**

9. The Government has considered two options:

Option 1: Do nothing (i.e. abolish contracting-out for DB schemes with no mitigating employer amendment power)

10. In this instance the do nothing option relates to doing the minimum needed to achieve the abolition of contracting-out without the provision of the employer amendment power. This option would depend on whether an employer could continue to run their scheme and adjust for the loss of the NI rebate.
11. Employers have asked for an option to mitigate the impact of the loss of the NI rebate. In the absence of an amending power employers might have to bear the cost of the loss of the NI rebate while maintaining the same occupational scheme benefits. Some employers are limited in their ability to modify scheme structure, for example, members with protected person status in legislation. In many cases scheme rules can only be changed by the trustees or with trustees' consent. As changes resulting from the abolition of contracting out are likely to be detrimental to members' workplace pension income, it is possible that trustees may not consent to them. Without the employer amendment power some employers may be more likely to close their scheme.

Option 2: Provide an employer amendment power for sponsoring employers from 2016 to mitigate the loss of the NI rebate

12. Introducing an amending power ensures that the vast majority of employers have a range of options available to them to mitigate the loss of the NI rebate.
13. Section 24(2) of the Pensions Act 2014 gives employers a limited power to amend scheme rules for this purpose without trustee consent. This power enables employers to make an adjustment to future pension benefits or contribution rates to offset the end of the NI rebate. The new power will be allowed to be used more than once so employers can phase in changes if they choose. However, any scheme changes must be certified by an actuary as

'recouping no more than' the employers loss of the NI rebate before proposed changes under the employer amendment power can be implemented. The amending power will only be available for 5 years after 6 April 2016.

## Preferred option

14. The Government's preferred option is option 2, to introduce an employer amendment power for private sector sponsoring employers as in the Pensions Act 2014.

## Monetised and non-monetised costs and benefits (including administrative burden)

15. The impact of the abolition of contracting-out on employee and employer NICs is considered in chapter 5 of "*The single-tier pension: a simple foundation for saving*" Impact Assessment:

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/311316/pensions-act-ia-annex-a-single-tier-state-pension.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/311316/pensions-act-ia-annex-a-single-tier-state-pension.pdf)

16. This Impact Assessment focuses on the costs and benefits associated with the provision of the employer amendment power.

### Individuals and schemes in scope of the employer amendment power

17. According to the Occupational Pension Schemes Survey (OPSS) 2013, (ONS)<sup>1</sup>, there are currently 1.3 million active members<sup>2</sup> of contracted-out DB schemes in the private sector (see Table 1). There has been a decline in the number of active members of contracted-out DB schemes in the private sector from 2.4 million in 2008<sup>3</sup> to 1.3 million in 2013, this reflects the wider decline in DB schemes in the private sector<sup>4</sup>. In 2012 there were 2,500 contracted-out DB schemes in the private sector.

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<sup>1</sup> <http://www.ons.gov.uk/ons/rel/fi/occupational-pension-schemes-survey/2013/index.html>

<sup>2</sup> Active members are those that continue to accrue new pension rights in a scheme.

<sup>3</sup> Historic figures from Contracting Out of Private Sector DB Schemes 2012 derived using OPSS data.  
[http://www.ons.gov.uk/ons/dcp171766\\_352604.pdf](http://www.ons.gov.uk/ons/dcp171766_352604.pdf)

<sup>4</sup> See for example '*Pensions: Challenges and Choices, -The First Report of the Pensions Commission*', 2004.

**Table 1: Number of active members of contracted-out DB schemes in the private sector, 2008-2013**

Year	Private Sector membership
2008	2.4
2009	2.1
2010	1.8
2011	1.7
2012	1.4
2013	1.3

Source: OPSS data

Note: Totals may not sum due to rounding

**Table 2: Number of contracted-out DB schemes, by size of membership in private sector in 2012**

Membership size	Private Sector
5000+	160
1,000-4,999	320
100-999	1,390
12-99	620
2-11	--
<b>Total</b>	<b>2,500</b>

Source: OPSS data 2011 and 2012

Note: Totals may not sum due to rounding

Data from table 2 showing the number of private sector occupational schemes with only one section: by size and route to contracting-out. Only contracting-out Salary Related Schemes are included here and '--' indicates cells that have been suppressed to protect confidentiality.

18. In April 2016, when the new State Pension is implemented and contracting-out is abolished, all employees who were members of a contracted-out scheme immediately before implementation will cease to receive the 'NI rebate' and will start to pay standard NICs, bringing them into line with the rate of NI that is paid by other employees.

#### Costs to private sector employers (option 2)

19. DWP sought the views of sponsoring employers in the private sector affected by the ending of DB contracting-out. Many respondents to the consultation indicated that employers thought it unreasonable that they had to bear the cost of paying higher NICs whilst maintaining the same scheme benefits. They therefore wished to reduce the level to which they must fund their scheme by the same amount as the loss of the NI rebate, reflecting the fact that employees would be brought back fully into the state pension system when

contracting-out ends. This could be done by reducing future pension benefits or increasing employee contribution rates to their pension schemes or a combination of the two.

20. The proposed the Occupational Pension Schemes (Power to Amend Schemes to Reflect Abolition of Contracting-out) Regulations 2015 do not impose any direct cost on employers. It sets out detail as to how employers may use the amending power. The use of the power is at the discretion of the employer. It is important to note that if employers choose to amend their scheme rules then there will be professional and administrative costs associated with making amendments, regardless of whether they use the amending power to effect that change. The amending power enables employers to make changes without trustee consent.
21. We do not know with any certainty the proportion of private sector employers sponsoring a contracted-out DB scheme that will use the employer amendment power. As noted in the White Paper, *“The single-tier pension: a simple foundation for saving”*, many employers have indicated a strong appetite for a mechanism to mitigate the impact of the end of contracting-out. For the purposes of the calculations presented here we have assumed that all schemes would use the amending power. This is in line with the assumption made in the single-tier Impact Assessment that employers would pass on the costs of the lost NI rebate to their employees immediately and in full by increasing employee contribution rates to their pension schemes, reducing future pension scheme benefits or a combination of both.
22. If employers choose to use the amending power to change their scheme rules there will be professional fees (legal and actuarial costs), administration costs and communication costs. These costs represent costs to changing their scheme and are voluntary and not imposed directly as result of the regulations. Industry sources have advised that the costs associated with using the amending power will vary depending on whether employers choose to change contribution rates or change future pension benefits. An increase in contribution rates is likely to be less complex and therefore cheaper to implement, whereas a change to future benefits is likely to be more complex to implement and therefore more costly.
23. Industry experts have suggested that if the change is relatively straightforward and a simple consultation exercise is undertaken, a large scheme (1000 plus members) may spend around £100,000 changing their scheme rules using the employer amendment power, a medium sized scheme (100-999 members) may spend around £50,000 and a small scheme around £20,000 (fewer than 100 members). If all private sector contracted-out schemes used the amending power the estimated cost of changing scheme rules would be around £130m in 2014/15 prices in 2016/17 (Table 3). These costs represent the costs associated with making voluntary changes to scheme rules to mitigate the impact of the NI increase and are not directly imposed as a result of the employer amendment power.

**Table 3: Estimated transitional costs of using the employer amendment power (2014/15 prices)**

Scheme Size	Number of Schemes	Estimated Cost per scheme £m	Estimated Cost £m
5000+	160	0.1	16
1000 to 4999	320	0.1	32
100 to 999	1,390	0.05	70
Below 100	620	0.02	12
<b>Total</b>	<b>2,500</b>	<b>-</b>	<b>130</b>

Source: DWP calculations and the Occupational Pensions Scheme Survey 2012

24. These estimates assume that the amending power is used only once and employers reduce their costs by the required amount first time. We have no information on how many times an

employer would use the powers, but the expectation is that employers will seek to minimise cost and use the power once only.

25. The Department received a number of responses to the consultation question about the estimates of the cost per scheme of using the employer amendment power: these costs ranged from the low thousands of pounds to £1.5 million; these costs could be reduced if linked to a triennial valuation. Given the level of uncertainty about the estimates of the cost per scheme and a number of organisations who were not able to provide an estimate, the Department has decided to keep its initial estimate of the cost per scheme of using the amending power.
26. Although there is a cost to employers of using the amending power it is a voluntary decision made by the employer to mitigate the ending of the NI rebate. Any costs incurred by the sponsoring employer in using the amending power would be in the expectation that these would be outweighed by the longer-term benefits of making these changes. As a consequence, we estimate that the benefits to employers if they all use the amending power, will be **greater than the £130m** estimated cost of implementing the changes required to scheme rules. The exact level of benefits will depend on what changes employers make to their scheme: they are limited to the maximum changes they make, but some may choose to make changes which do not fully reflect the loss of the NI rebate.
27. If not all schemes use the employer amendment power then the costs and benefits would be lower, but as the amending power is voluntary, we would still expect the benefits to outweigh the costs. For example, some employers may not use the amending power if there are positive but relatively modest (and uncertain) net returns from using it or if they have reached agreement with the trustees to how the scheme may be amended.

### Protected Persons

28. There is a small group of individuals (approximately 70,000) employed in some formerly nationalised industries (rail, London Transport, electricity, coal, nuclear waste and decommissioning), where the employers and trustees are limited in their ability to change scheme rules by legislation made during privatisation. This legislation prevents employers from making changes to the pension benefits offered to those employees who were previously employed by the State.
29. The Government response to the consultation document which accompanies this Impact Assessment specifies details in regulations<sup>5</sup> by defining in provision a “protected person in relation to a scheme” and that employers should not be allowed to use the amending power to alter the pension schemes in relation to members with protected person status on the amendment date or later (i.e. when the changes made by the employer take effect). We do not have reliable information to robustly quantify this impact; therefore no allowance has been taken for protected persons in the calculations presented here.
30. Further details on protected persons can be found in the Government’s response to the protected persons consultation and in the supporting Impact Assessment:

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/278979/government-response-protected-persons-consultation.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/278979/government-response-protected-persons-consultation.pdf)

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/278982/impact-assessment-protected-persons.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/278982/impact-assessment-protected-persons.pdf)

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<sup>5</sup> Regulation 3 of the Occupational Pension Schemes (Power to Amend Schemes to Reflect Abolition of Contracting-out) Regulations 2015

## Risks and Assumptions

31. The main assumptions used in the estimates are:

- all private sector employers sponsoring contracted-out DB schemes will use the amending power; this implies that the full cost of the loss of the rebate is passed on immediately to employees in the private sector;
- the costs associated with using the amending power to change scheme rules without trustee consent are £100,000 for schemes with greater than 1000 members; £50,000 for schemes with 999-100 members; and £20,000 for schemes with fewer than 100 members, based on information provided confidentially by industry;
- the costs associated with using the amending power occur in 2016/17.

32. There is uncertainty around the estimates of the one-off cost of using the employer amendment power. This is because we do not know with any certainty what proportion of employers sponsoring contracted-out DB schemes will in fact use the amending power. In addition there are also uncertainties around the costs associated with using the amending power which will be influenced by whether employers increase contributions or change future benefits and the nature of the consultation exercise. The estimate of the costs associated with using the amending power is based on Occupational Pension Scheme Survey (OPSS) data about the number of contracted-out private sector DB schemes and the size of these schemes. Data on scheme numbers is weaker than other OPSS estimates as the survey is designed primarily to measure membership numbers. We also assume that the amending power is used only once. The expectation is that employers will seek to minimise cost by using the amending power once.

33. The estimate of the costs of using the amending power to change scheme rules without trustee consent should be interpreted with caution given the uncertainties outlined above. Nevertheless, as use of the employer amendment power is voluntary, employers choosing to use the amending power to change their scheme rules without trustee consent are likely to do so in the expectation that the longer-term benefits will outweigh the short-run costs associated with changing scheme rules.

## Small and micro businesses

34. The majority of contracted-out DB schemes are large and medium-sized. However, the Department recognises that some small and micro businesses will be affected by the ending of DB contracting-out. The availability of the amending power will ensure that the vast majority of private sector employers, of any size, have a range of options to mitigate the impact of the loss of the NI rebate.

## Summary and implementation plan

35. The Occupational Pension Scheme (Power to Amend Schemes to Reflect Abolition of Contracting-out) Regulations 2015, which provide the detail of how the employer amendment power will operate, will be laid in Parliament in the spring, to come into force on 6 April 2016. This allows employers to plan changes and to consult employees in good time to implement. The earliest that amendments made by the employer could come into effect is April 2016.