Title: Introduction of legislative framework for Defined Ambition pension schemes **IA No:** DWP0043 **Lead department or agency:** Department for Work and Pensions **Other departments or agencies:**	**Impact Assessment (IA)** **Date:** 11.04.2014 **Stage:** Final Proposal (Pensions Bill 2014) **Source of intervention:** Domestic **Type of measure:** Primary legislation **Contact for enquiries:** Shyamala Balendra (0207 449 7623)

Summary: Intervention and Options

RPC Opinion: Green

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present**	**Net cost to business per year** (EANCB on 2009	**In scope of One-In, Two-**	**Measure qualifies as**
Zero	Zero	Zero	Yes	**Zero net cost**

What is the problem under consideration? Why is government intervention necessary?

The provision of pensions involves financial, economic and longevity risks, all of which come with significant costs. The two models dominating existing provision, Defined Benefit (DB) and Defined Contribution (DC) place all of these risks and associated costs with the sponsoring employer and individual member respectively. Pension scheme designs which allow for these risks to be shared, resulting in less risk placed on any one party, are limited by current pensions legislation. Following extensive consultation and collaboration with industry, Government is intervening to create a legislative framework that enables new types of risk-sharing in pension schemes, as well as allowing schemes to offer collective pensions.

What are the policy objectives and the intended effects?

The objective is to encourage the pensions market to develop new types of pension provision in the form of Defined Ambition (DA) schemes through explicit recognition of such schemes in legislation and through clarifying the legislative framework for different types of pension schemes (DB, DC and DA). By creating this legislative framework Government intends to encourage a new class of risk-sharing (DA schemes) in order to provide more certainty in terms of retirement outcomes for members than DC schemes and to create greater choice regarding pension scheme design. The legislation will also allow schemes to offer collective pensions, which pool risks among the membership.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Option 0: doing nothing would not change the current trends. Pensions risk would continue to be concentrated with the individual member – existing DB schemes would continue to close, with DC schemes being opened in their place. Discussions with employers and consumer groups demonstrate demand for risk-sharing. Individuals generally find it difficult to understand and bear pensions risk and so some degree of risk sharing is desirable – consumer research also indicates a desire for certainty in pension outcomes that DC plans do not currently provide. The current legislative framework inhibits risk-sharing – both in variety and extent – with employers effectively forced to choose between DB or DC. The only way to change this is to create a framework for risk-sharing schemes via Option 1: bringing in new legislation that specifically defines such risk-sharing schemes in UK pensions law. A non-legislative approach is therefore not an option to deliver this policy intention. The legislation will also for the first time define collective benefits in order to allow schemes to offer them in the UK – something which is not currently possible.

Will the policy be reviewed? Yes **If applicable, set review date:** 2019

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.	Micro Yes	< 20 Yes	Small Yes	Medium Yes	Large Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:**	**Non-traded:**	

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: Steve Webb **Date:** 11.04.2014

Summary: Analysis & Evidence

Policy Option 1

Description: Introduction of legislative framework for Defined Ambition pension schemes

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low:	High:	Best Estimate:

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0		0	0
High	0		0	0
Best Estimate	0		0	0

Description and scale of key monetised costs by 'main affected groups'

Other key non-monetised costs by 'main affected groups' The legislative framework is intended to create a clear 'DA' space in legislation to encourage innovation in risk sharing, enable collective models, and ensure appropriate regulation according to scheme type (DB, DC and DA). The DA framework introduces more choice for members, employers and pension providers. The introduction of the new framework may create some costs for all current schemes as they need to assess how the new definitions apply to them and identify themselves under the new framework (as DB, DC, or DA). We will be drafting the legislation to make this as simple as possible, and considering how to support delivery via commencement of primary provisions to minimise these costs.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0	0
High	0		0	0
Best Estimate	0		0	0

Description and scale of key monetised benefits by 'main affected groups'

Other key non-monetised benefits by 'main affected groups' The main benefit of the new DA framework is that it will allow for the creation of a new class of pension schemes that share pension risks between members, employers, and pension providers. This will increase the degree of certainty and stability in pension outcomes for members, in comparison to a counterfactual of DC pension provision. Depending on the market response to the introduction of the DA framework, this could result in greater provision of schemes in the market which could benefit members, employers and insurance companies. The greater specificity about the regulation of risk sharing schemes may reduce costs to providers and schemes already operating in the risk sharing space.

Key assumptions/sensitivities/risks **Discount rate**

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of	Measure
Costs: 0	Benefits: 0	Net: 0	Yes	Zero net cost

Evidence Base

Problem under consideration

1. Longstanding trends in the UK workplace pension system have resulted in a shift of all the risks in pension saving from employers to individual members. The practical consequence of this has been a significant increase in the level of uncertainty that individuals face in relation to their income in retirement, which depends directly on economic, financial and demographic factors. This can impose severe costs on individuals, particularly if their retirement income prospects change significantly due to these factors just prior to retirement. It is legitimate to question the sustainability of this systemic shift of risk to the individual.

The current structure

2. Currently defined benefit (DB) and individual defined contribution (DC) structures dominate the workplace pensions market.
   - DB – typically takes the form of a workplace pension in which an employer promises an income in retirement, or a specific level of pension savings, based on a formula related to the person's salary and/or the length of time they have been in the scheme.
   - DC – a pension scheme that provides benefits based on the contributions invested, the returns received on that investment (less any charges incurred) and – if the pension is used to buy an annuity or provide an income via a drawdown product - the rate at which the final pension fund is converted into a retirement income.

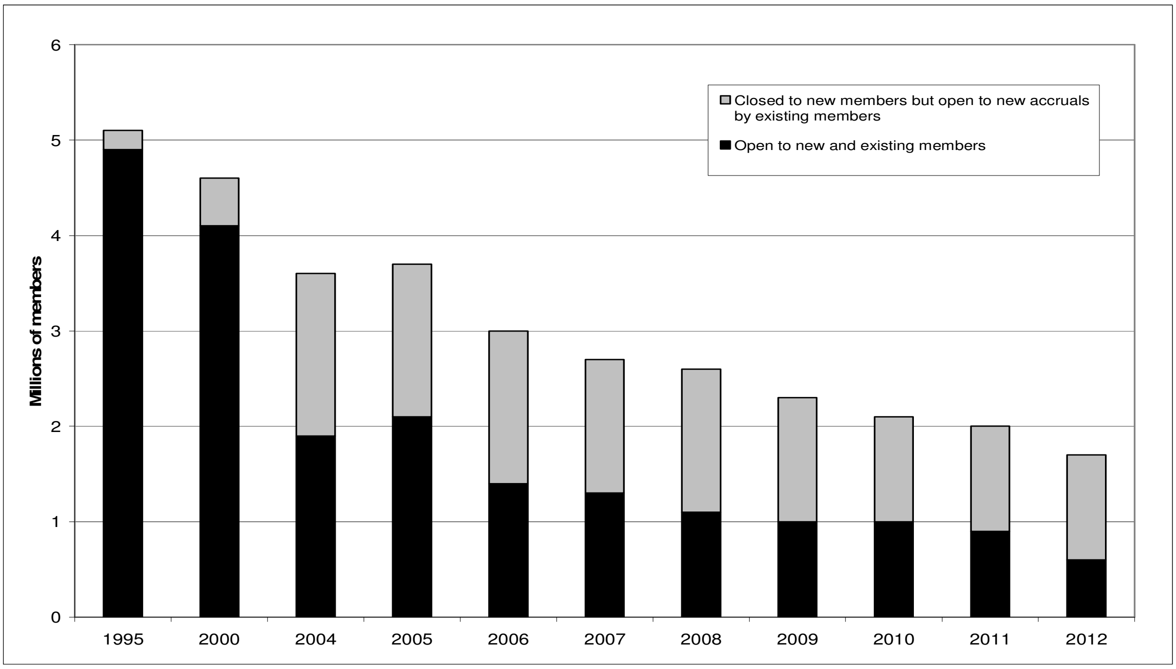
3. A key difference between these scheme types is who bears the risks. In DB schemes, the longevity, investment and inflation risks are borne by the employer who sponsors the scheme. However, in DC schemes, the individual scheme members bear the investment risks and also have no certainty of the size of their income in retirement.

The Shift

<u>Decline of DB schemes – employer sponsored schemes where benefits accrue on a specified basis</u>

4. DB schemes are in decline. The chart below shows the picture since the mid-1990s, although the decline has been going on for much longer.

Chart 1: Active membership of private sector DB schemes by scheme status

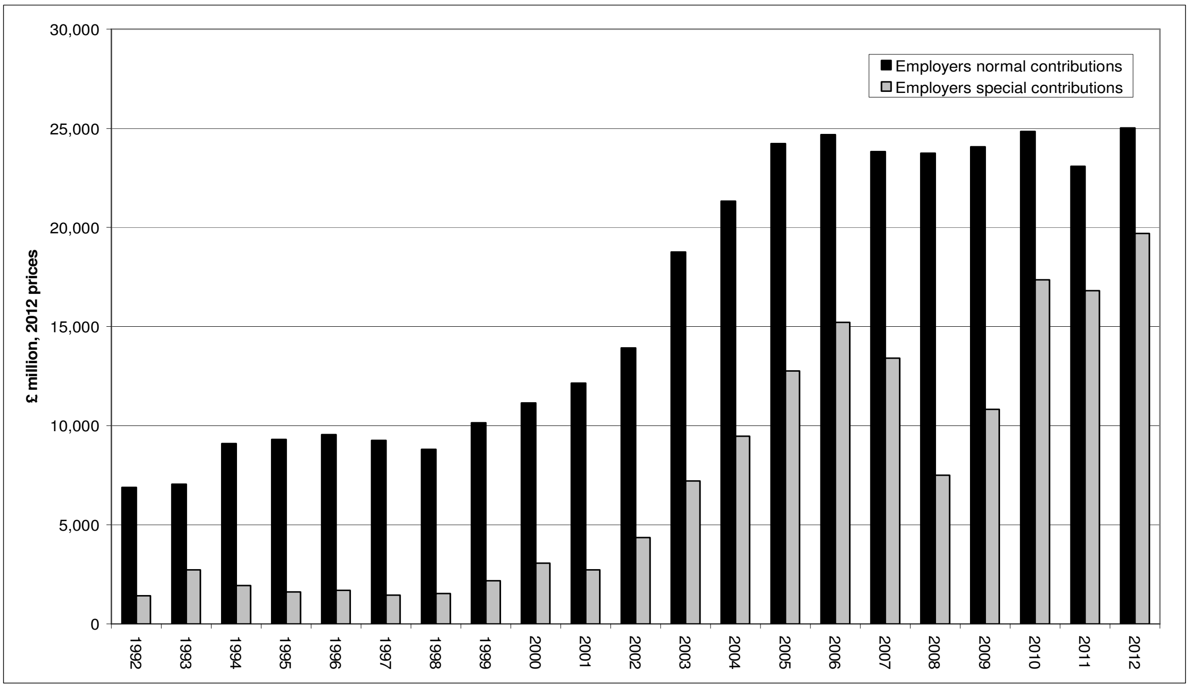


Source: Occupational Pension Schemes Survey, ONS, various years.

5. This illustrates the decline in membership of private sector DB schemes in recent years. Total active membership of DB schemes peaked in the 1960s at 8.1 million, and has fallen to 1.7 million by 2012 – with membership of open DB schemes dropping by 300,000 in that year alone (from 900,000 to 600,000).

6. This decline has been driven by rising costs of DB provision – in turn due to rising longevity, falling bond yields, more volatile financial markets and regulatory changes that have tightened the framework under which pension promises are funded. The following chart shows how costs have grown since the early 1990s.

Chart 2: Employer contributions to funded DB pension schemes



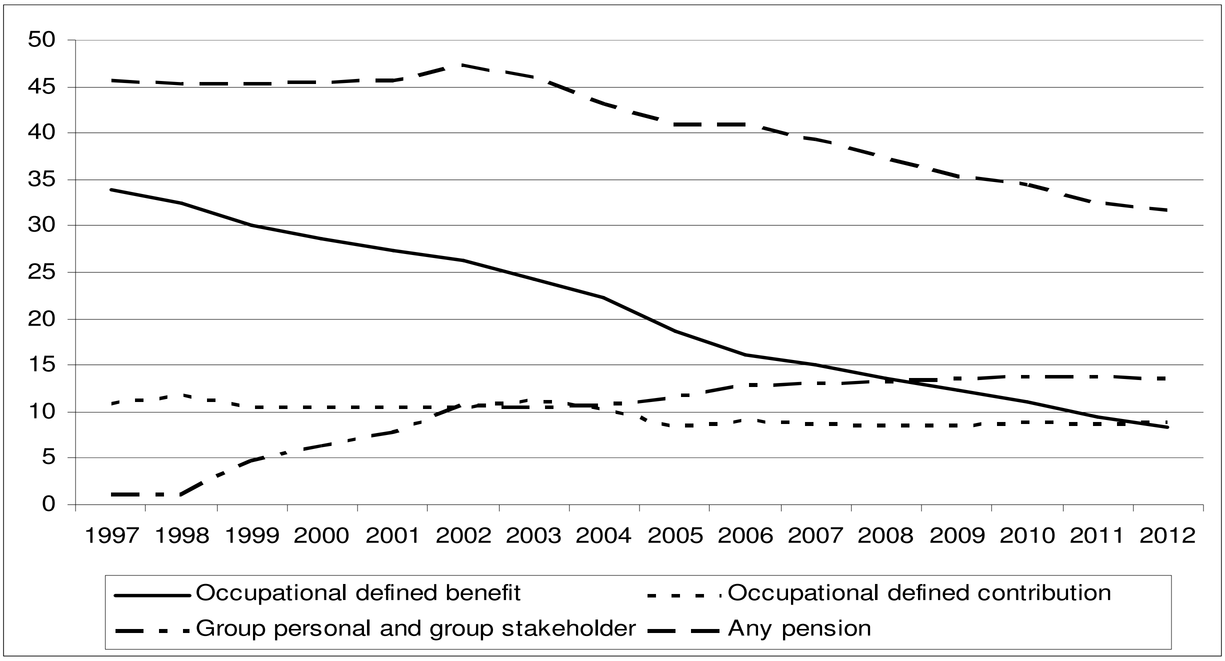
Source: MQ5 - Investment by Insurance Companies, Pension Funds and Trusts, ONS

Notes: Chart shows employer contributions to 'self-administered pension schemes' – this is all funded DB provision and therefore includes the funded public sector schemes. However, the vast majority of these costs relate to private sector schemes. 'Normal' contributions are those which are calculated to cover the cost of benefits on an on-going basis. 'Special' contributions are those made to close any deficits that open up over the course of market cycles

Growth of DC

7. This decline in workplace DB provision has been accompanied by a growth in workplace DC provision, particularly in the contract-based sector of the market, in which employers facilitate the provision of a pension and pay in contributions, but the contract exists between the individual scheme member and the pension provider. This change in the structure of the UK pensions market is shown in the chart below.

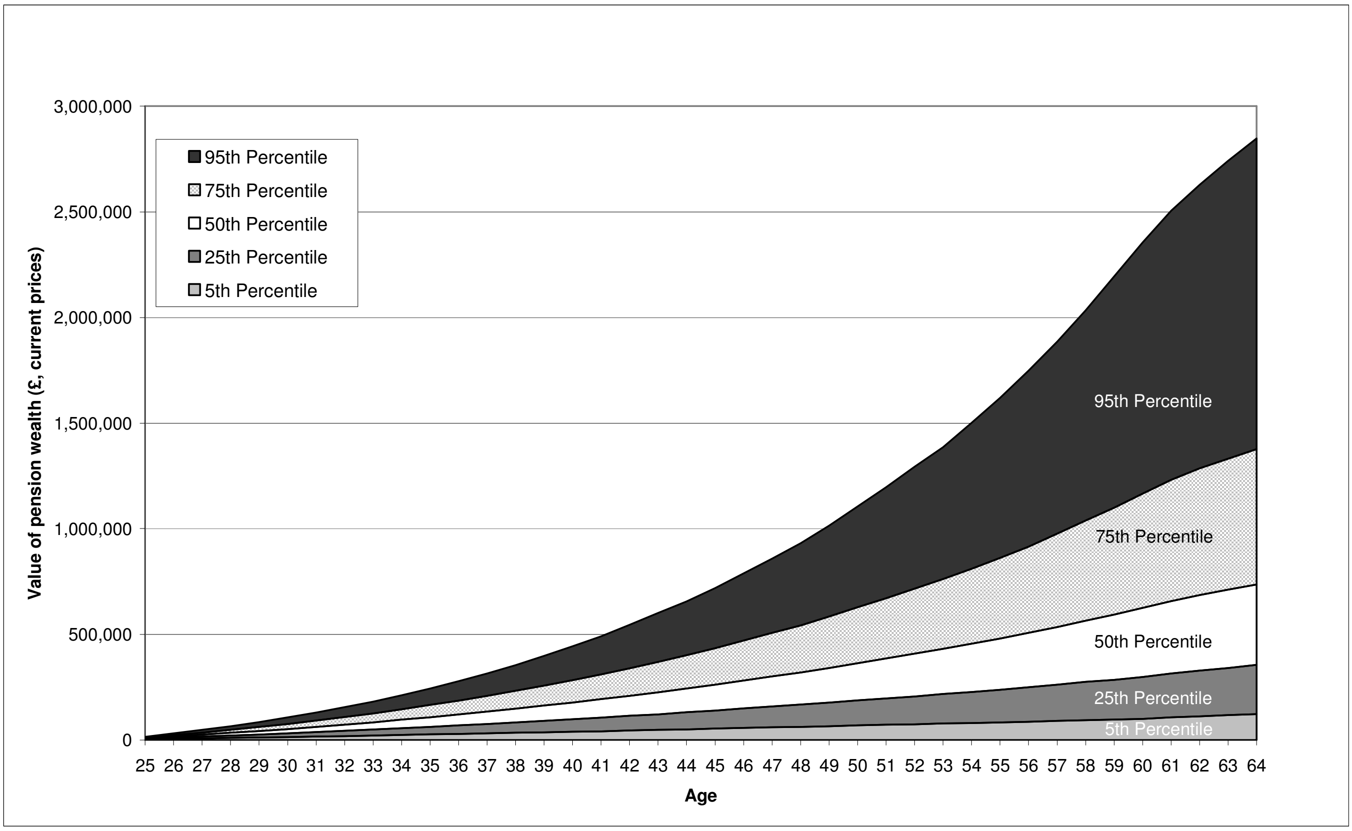
Chart 3: Proportion of private sector employees with workplace pensions by type of arrangement



Source: ONS, 2012 Annual Survey of Hours and Earnings (UK)

8. Given the long-standing nature of the DB-DC shift, it is expected that the vast majority of people automatically enrolled into workplace pensions under the Government's pension reforms will be saving into DC pension plans.
9. The implication of this shift from DB to DC is that all the risk inherent in pension saving – investment, inflation and longevity – has been shifted from the sponsoring employer to the individual. The corollary of this is that the level of uncertainty over future pension outcomes faced by members is very high. An example of this is shown in the chart below, which illustrates the degree of uncertainty faced by individuals saving in DC pensions, who have a 90 per cent probability of ending up anywhere within the range shown on the chart – in comparison to the certainty provided by DB pension wealth, which builds up smoothly over time.

Chart 4: Accumulation of wealth in pensions – a comparison of DB with DC



Source: DWP modelling.

Notes: Based on an individual saving continuously into a DC pension for forty years with a constant annual rate of contributions. DC asset allocation is based on a typical lifestyle fund, with a shift from equities into fixed income and cash beginning ten years before retirement.

<u>Gap in the current pensions market</u>

Providing greater certainty for members in the DC pension environment

10. For many employers and employees the future is DC pension provision. This can be the right product for some, but traditional DC pensions do not provide certainty to scheme members in relation to pension income.
11. Since individuals generally find it difficult to understand and bear pensions risk and consumer research (see below) indicates a desire for certainty in pension outcomes that DC does not currently provide, there is currently a significant gap in the DC market for risk-sharing pension products that allow providers, insurers or employers to provide forms of guarantee for members at an acceptable cost, and for that cost and the value of the guarantee to be communicated simply and clearly.

Rationale for intervention

12. The current legislative framework means that on the whole employers have to choose between offering DB or DC pensions, because the legislation recognises little in the way of alternative scheme types. Without Government intervention therefore, different pension arrangements that provide greater risk sharing are highly unlikely to be offered. The Government's proposals will make it easier for pension providers and employers to offer workplace pensions that give members more certainty than DC schemes. This therefore builds a 'middle ground' for risk sharing in workplace pensions – striking a balance that does not leave either individuals or employers shouldering all the risks of pension saving.

Policy objective

13. The Government set out its ideas for a new legislative framework in its November 2013 command paper *'Reshaping workplace pensions for future generations'.*[1] The ideas in that document were produced in collaboration with a series of working groups from the pensions industry and reflect the needs and desires of employers offering pension provision and the employees who will benefit from these pension schemes.

14. Following that collaborative process, the Government is now bringing forward legislative proposals that are designed to facilitate greater risk sharing in workplace pensions through a legal framework that will allow more choice for pension providers and employers on the type of workplace pension schemes offered to employees. The Government proposes to encourage the pensions market to develop new types of pension provision in the form of DA schemes through explicit recognition of such schemes in the legislation and through clarifying the legislative framework for different types of pension schemes (DB, DC and DA).

Description of options considered (including do nothing)

The counterfactual – the continuation of the DB-DC shift and the increased concentration of pensions risk with the individual

15. The problem defined above makes clear that in the absence of any action, the cost of DB provision means that it will further decline, to be replaced by DC provision, with a resulting transfer of all pensions risk to the individual. This will lead to significant uncertainty for individuals over their future levels of retirement income.

16. The Government's recent Budget reforms also underline the need for further action to make real choices available.

The overarching 'Defined Ambition' (DA) legislative framework

17. We propose legislation to enable the creation of Defined Ambition (DA) schemes. This means creating new definitions for DA, DB and DC schemes (incorporating Money Purchase Scheme definition). The legislation will also for the first time define collective benefits in order to allow schemes to offer them in the UK – something which is not currently possible. By moving away from the polarity created by existing definitions, giving explicit recognition in legislation to the potential for innovation in risk sharing in the middle ground, these changes will give pension providers and advisers more space to innovate, and thereby provide employers and individuals more choice over the type of pension scheme they use.

18. The creation of a new legislative framework creates the space in legislation for DA schemes that allow for greater risk sharing and gives the member greater certainty over outcomes than a pure Defined Contribution scheme.

19. There is the possibility that the creation of the legislative framework will create some costs for current schemes arising from the changes - in relation to the need for schemes to identify themselves under the new framework. These are detailed in paragraphs 30 and 31 below.

20. The Government does not intend to prescribe the features of the DA models in legislation – the intention is to create the space to enable market innovation in product design. The models previously discussed in the Government's *'Reshaping workplace pensions for future generations'* command paper are simply used to start testing what current legislative barriers might impede innovation. The models do not describe every possible form of DA.

Monetised and non-monetised costs and benefits

21. The creation of a new legislative framework will give providers and employers more *choice* in pension provision. The net social benefit from creating the Defined Ambition framework is to provide individuals with increased certainty about their future pension income than is currently the case, given the counterfactual of the continuing shift to DC provision. This increased certainty will ultimately make it easier for individuals to plan for their retirement and see clearly how much they need to save for the type of retirement that they wish to have.

Non-monetised benefits – the introduction of the 'Defined Ambition' legislative framework

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[1] 'Reshaping workplace pensions for future generations' (Cm 8710), DWP, November 2013. Available to download at https://www.gov.uk/government/consultations/reshaping-workplace-pensions-for-future-generations

22. The existing UK workplace pensions legislative framework is, broadly speaking, binary in nature with employers only able to choose between offering DB and DC schemes. While there does exist the possibility for some limited forms of risk sharing pension provision such as Cash Balance and hybrid schemes, industry stakeholders have highlighted that the lack of legislative clarity around risk sharing schemes more generally is likely to have limited innovation in this space.

23. The introduction of a new legislative framework for Defined Ambition schemes will, for the first time, provide the legislative clarity needed to encourage both new and existing risk sharing options. This Impact Assessment does not consider the precise impacts of the different designs of pension schemes because what the Government is introducing is a new legislative framework that allows the market to develop a range of innovative new scheme designs (i.e. DA schemes). It is not requiring employers to offer DA pension models; ultimately the scheme design selected is a matter of choice for the employer. The employer is not required to bear more risk through the introduction of this legislative framework however they are likely to benefit from greater scheme choice.

24. These new scheme types are designed to provide the employer with greater flexibility and control over pension-related costs while still allowing them to provide a degree of certainty to their employees in respect of pension outcomes. There may be financial benefits (uncertain in nature) accruing to sponsoring employers where the counterfactual is a DB scheme (since the cost of all these risk-sharing options is expected to be lower than existing DB provision); where the counterfactual is a traditional DC scheme, the main benefit to the employer comes via the ability to offer increased certainty to their employees without taking on any formal pensions liabilities. In general the evidence provided by the long-standing shift from DB to DC pensions in the UK, and elsewhere, shows that the counterfactual for most employers will be DC provision.

Enabling schemes that create less liabilities for employers (than defined-benefit schemes)

25. The proposed new legislative framework creates the space within the current legislation for employers to offer DA schemes to their employees enabling employers to limit their risk in comparison to DB schemes. The proposals will not affect DB legislation – and all existing rights under DB pensions, and their associated protections, will remain unchanged.

26. We have also heard expressions of interest in new forms of risk-sharing from employers who are concerned that traditional DC schemes may create workforce management problems for them in the future if employees cannot plan or afford to retire with any certainty. There is therefore an intangible, but important, benefit for employers from these proposals.

27. The proposed legislation would also enable the creation of schemes that offer collective benefits. Schemes that offer collective benefits may take different forms and come with different levels of guarantee (including none at all). For the employer sponsoring schemes that offer collective benefits (as with money purchase schemes) their liability is limited to the employer contribution (unless the employer itself chooses to stand behind any guarantee offered). The employer therefore does not bear any of the investment, inflation or longevity risks which are associated with other non-money purchase schemes.

Greater certainty of pension outcomes for employees relative to a defined-contribution scheme

28. The value placed by people on greater certainty in pension outcomes is an inherently subjective variable which will differ on an individual basis. It is therefore impossible to quantify the benefits. However, it is known that individuals value greater certainty in pension provision – for example the ‘Attitudes to Pensions’ survey[2] shows people tend to be risk-averse with their saving; over two-thirds of respondents agreed with the statement that ‘it is better to play safe with your savings, even if investing in higher risk investments could make you more money’, while just eighteen per cent took the opposite view. This view varied little between those with different levels of pension knowledge. On the basis of evidence such as this, it can be inferred that the sharing of risk and the provision of greater certainty, will bring a genuine benefit to individuals in comparison to the often random fluctuations and huge uncertainty of outcomes in existing DC schemes.

Greater clarity of scheme type for employers and employees

[2] Attitudes to pensions: The 2009 survey, DWP research report no. 701, 2010.

29. The proposed legislation aims to distinguish between DB, DC and DA schemes to allow schemes to be transparently regulated according to type. This distinction will provide greater clarity for employers and employees in terms of scheme type and the corresponding liabilities.

The trade-off between greater certainty of pension outcomes and the cost of guarantees

30. The benefit to members comes in the form of increased certainty in pension outcomes compared to DC schemes, through the provision of formal guarantees or promises by some counterparty, which could include insurance companies, for example. It should be noted that this increased certainty comes at a cost to the member because the provision of certainty requires a counterparty to bear some risk. In particular, a guarantee provider will use the financial markets to make investments that will be used to back the guarantee. If these investments do not deliver, in the event of the guarantee biting, the guarantee provider must make good on the guarantee. This risk imposes a cost on the provider and so they will charge a premium to the guarantee purchaser to reflect this risk. This guarantee charge will reduce the return on the product being insured.

Direct costs and benefits to business calculations

31. Through the introduction of the DA framework we expect some costs for schemes to arise from the changes. There is the possibility of some costs for all current schemes arising from the proposed changes – these arise from the need for all current schemes to assess how the new definitions apply to them and identify themselves under the new framework. We do not have reliable information to quantify the costs or benefits of the primary proposals. The main benefit will be to give employers more choice and flexibility over their pension arrangements. For individuals, the benefit is the increased certainty and stability of pension incomes derived from DA schemes relative to DC schemes.

32. We will be drafting the legislation to make this as simple as possible, and considering how to support delivery via commencement of primary provisions to minimise these costs.

Wider impacts

33. By creating a legislative framework for pensions in the UK, employers will have greater choice and flexibility over scheme design and individuals will see a greater degree of certainty in their pension income than is currently on offer in existing DC schemes. Such benefits may even make pension saving more attractive, with the potential of an increase in the overall level of savings.

34. There may also be a wider macro-economic benefit because some of the pension scheme designs that could be made possible under a Defined Ambition legislative framework would be better suited than existing DC provision to investing for the longer term in illiquid assets such as infrastructure, which are hard for retail investors such as DC pension savers to access.

Small Business Assessment

35. The Government believes that small and micro-employers should have access to the full range of pension scheme options available to other employers – with employers free to select the scheme design that suits them best. With the roll-out of automatic enrolment we expect the majority of small employers to provide DC schemes meaning the introduction of this legislative framework will not have any impact on the majority of these schemes, other than to offer them alternatives which they may or may not wish to take up.

Summary and preferred option with description of implementation plan

36. As discussed above, the Government's intention is to create a framework to enable DA pension schemes. Introducing the DA legislative framework will require primary legislation and will be achieved through a Private Pensions Bill in the Fourth Session of Parliament .The Government would then anticipate the Bill receiving Royal Assent before the end of the Fourth Parliamentary Session.