Title: The Pensions Act 2014 (Contributions Equivalent Premium) (Consequential Provision) and (Savings)(Amendment) Order 2016 **IA No**: DWP2016_02 **Lead department or agency:** Department for Work and Pensions **Other departments or agencies:** HMRC **THIS IS A REVISED AND FINAL IMPACT ASSESSMENT**[1]	Impact Assessment (IA) **Date:** 24/03/2016 **Stage:** Validation **Source of intervention:** Domestic **Type of measure:** Secondary Legislation **Contact for enquiries:** laura.webster@dwp.gsi.gov.uk
Summary: Intervention and Options	**RPC Opinion:** Validated

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2014 prices)	**In scope of One-In, Three-Out?**	**Measure qualifies as**
£72.95m	£72.95m	£-35.28m	Yes	Out

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

Managers of a contracted-out salary-related occupational pension scheme may and, in some circumstances must, make a contributions equivalent premium (CEP) to Government when a member of a contracted-out scheme member leaves their employment with less than two years' pensionable service. In effect a CEP buys the member back into the additional State Pension. Current legislation, however, could be interpreted as requiring schemes to pay a CEP when contracting-out is abolished where a member has not yet accrued any rights. This is contrary to the policy intention as the member may remain a member of the scheme after abolition, pass the two years' pension service point and accrue rights in the scheme. A CEP should only be required to be paid in respect of a member who ceases to be a member after abolition without having accrued rights in the scheme.

What are the policy objectives and the intended effects?

The Government wants to ensure a smooth end to contracting-out and to avoid unnecessary burdens on schemes at this point. Lack of clarity poses a significant risk to that policy objective. Government proposes to clarify legislation so that the CEP arrangements are operated in line with the policy intention - that a CEP is not required to be paid at abolition where a member remains in pensionable service and without having accrued rights in the scheme. The policy intent is that a CEP may be paid if the member remains in the scheme after abolition and ceases to be a member with less than two years employment and must be paid if such a person has no accrued rights.

[1] IMPACT ASSESSMENT HAS BEEN REVISED FOLLOWING OPINION FROM THE REGULATORY POLICY COMMITTEE (RPC). See opinion number: RPC-3283(1)

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

The policy cannot be achieved through non-legislative options, as prescribed requirements are set out in legislation.

Option 1: Do nothing. If the legislation is not clarified, trustees or managers may pay a CEP contrary to the policy intention.

Option 2: We propose to amend legislation to clarify that a CEP is not required where contracting-out ends and the member remains in the scheme. But if the member subsequently ceases to be a member of the scheme without having accrued any rights in the scheme, then the legislation provides that a CEP must be paid.

Option 2 is the preferred option. We propose to clarify the legislation to ensure that a CEP will not be made contrary to the policy intention on the 6 April 2016. We consulted informally with stakeholders who made a number of points about the detail of the drafting.

Will the policy be reviewed? No	**If applicable, set review date:** N/A				
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 CO2 equivalent change in greenhouse gas emissions? (Million tonnes CO2 equivalent)			**Traded:** N/A		**Non-traded:** 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: Ros Altmann Date: 20/05/2016

Summary: Analysis & Evidence

Policy Option 1

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2015	PV Base Year 2016	Time Period Years 2	Net Benefit (Present Value (PV)) (£m)		
			Low: £63m	High: £83m	Best Estimate:£73m

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

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

We estimate there to be one-off familiarisation costs of around £4k, based on the value of time for scheme administrators for the 768 open Defined Benefit schemes to read and understand no more than two pages of text. This is negligible in the EANCB calculation.

Other key non-monetised costs by 'main affected groups'

Not applicable

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low			£32m	**£63m**
High			£42m	**£83m**
Best Estimate			£37m	**£73m**

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

We estimate that there will be a saving to employers with Defined Benefit schemes of approximately £72m, based on the number of CEP payments expected to be paid contrary to the policy intention and administrative costs of £2m in the counterfactual (do nothing). This represents a transfer from the exchequer back to business for the £72m CEP payments.

Other key non-monetised benefits by 'main affected groups'

There is a benefit to HMRC of not having to process additional CEP payments.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

As there is no centralised set of data on individuals eligible for CEP payments or existing forecast of CEPs we have used a combination of an existing Departmental pensions model, latest figures from HMRC, The Pension Regulator and surveys such as the Annual Survey of Hours and Earnings to estimate the number and value of additional CEPS in the counterfactual. A key assumption is the rate of compliance, where we use a range of 75% to 100% to produce high, low, and central estimates.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OITO?	Measure qualifies as
Costs:	**Benefits: - £35.3m**	**Net- £35.3m**	Yes	OUT

Evidence Base (for summary sheets)

Problem under consideration

1. The State Pension is being reformed from 6 April 2016 into a single-tier pension – the "new State Pension" – for future pensioners. The introduction of the new State Pension means that there will no longer be an additional State Pension from which to contract-out. Consequently, contracting-out and the National Insurance (NI) rebate (employer and employee pay a lower rate of NI contributions) will come to an end in April 2016.

2. Trustees or managers of a contracted-out Defined Benefit (DB) occupational pension scheme sponsored by an employer are required to make a payment to Government - known as a 'contributions equivalent premium' (CEP) - when a member of a contracted-out pension scheme ceases to be a member of the scheme without having accrued any rights in the scheme. The purpose of a CEP is to buy the member back into the additional State Pension so that they do not lose out. The member is then effectively treated as if they had not been contracted-out of the state system. Trustees or managers are required to notify HMRC where a CEP is appropriate so that they can recalculate the correct amount of State Pension entitlement.

3. Trustees or managers of a pension scheme may interpret the legislation to require them to pay a CEP at the point that contracting-out is abolished (6 April 2016) to a member with less than two years' service, although the member may remain a member of the scheme after abolition. This is not what is intended - the policy intention is that a CEP should only be paid in respect of a member with less than two years' service. A CEP is appropriate, however, if the member remains in the scheme after abolition and subsequently leaves with less than two years' employment and no accrued rights.

Rationale for intervention

4. The Government wants to ensure that there is a smooth end to contracting-out on 6 April 2016. It does not want schemes wasting resources, because of a lack of clarity in the legislation, and paying CEPs contrary to the policy intention.

5. The policy cannot be achieved through non-legislative options, as the requirements are set out in legislation. If the legislation relating to CEPs is not clarified, trustees or managers may pay a CEP contrary to policy intention.

Policy objective

6. To ensure that there is no ambiguity for schemes and the sponsoring employers in relation to payment of CEPs which should only be required to be paid in respect of a member who ceases to be a member of a scheme without having accrued any rights in the scheme – the abolition of contracting-out should not trigger a CEP payment. A CEP is appropriate, however, if the member remains in the scheme after abolition and subsequently leaves with less than two years employment and no accrued rights.

Description of options considered (including do nothing)

7. Option 1: Do nothing. If the legislation is not clarified, trustees or managers may pay a CEP contrary to policy intention.

   Option 2: We propose to amend legislation to clarify that a CEP is not appropriate where contracting-out ends and the member remains in the scheme. But if the member subsequently leaves with less than two years' service and no accrued rights in the scheme, then the legislation provides that a CEP must be paid.

8. Option 2 is the preferred option. We propose to clarify the legislation to ensure that a CEP will not be made contrary to the policy intention on the 6 April 2016. We consulted informally with specialist stakeholders on draft legislative changes and received comments on the detail of the drafting changes.

Monetised and non-monetised costs and benefits of each option (including administrative burden)

9. If the legislation is not clarified, trustees or managers may pay a CEP contrary to the policy intention and experience an additional administrative burden.
10. We estimate the potential amount of CEP payments made contrary to policy intention to be between £62m and £82m.
11. The estimated administrative costs saved by pension schemes or their administrators are in the region of £2m.
12. We have considered familiarisation costs and concluded that there would be a very small amount of information that scheme administrators would need to consider as a result of the change in legislation, amounting to an estimated £4k total cost.

Rationale and evidence that justify the level of analysis used in the IA (proportionality approach)

13. The methodology used in the costing of this policy impact is conceptually relatively straightforward as there is a direct saving to businesses and pension schemes by not paying a CEP contrary to the policy intention, but there is a lack of available data.
14. The clarification of the legislation will impact a subset of people in DB schemes and is a technical change with a one-off transitional impact. In order to estimate the cost and savings to business DWP analysts have estimated the impacts using an existing Departmental model called PENSIM2.
15. It is necessary to use modelled data because there is no existing pension industry data on the number of people who may be eligible for CEPs on 6th April 2016. HMRC collect annual data on the value of CEPs paid and the average CEP payment made, which is used as a benchmark to check modelling outputs.
16. Each pension scheme is run commercially and independently and therefore does not routinely share working level data to government or external regulators. This means that we are unable to identify specific individuals in the DB universe who may be impacted by not clarifying the legislation. It would

cost a significant amount of money and time to build a bespoke survey which is why a modelling technique has been identified as the most proportional approach.

17. PENSIM2 is a dynamic micro-simulation model of pensioner incomes in Great Britain. It is primarily designed to model the distributional impact of state and private pension reforms on individuals over the period to 2100. A single run of the model begins with the 'base data': a synthetic representative sample of 60,000 individuals from the GB population, currently for the year 2011/12. The model then simulates a series of events for each individual in each year and models state and private pension policy. A user of the model can change policy rules or the probability of a particular event occurring, compare with a baseline run of the model and estimate the impact of the change.

18. The base data for the model uses information on an individual's current personal and household circumstances; and detailed information on their labour market history created by statistically matching individuals from the Family Resources Survey (FRS), British Household Panel Survey BHPS) and the Lifetime Labour Market Database (L2). The FRS has detailed information on people's current personal characteristics, other household characteristics and current labour market status. The L2 is a 1% sample of National Insurance records taken from HMRC administrative data since 1975 and so has the detailed labour market histories needed to estimate someone's accrued rights to state and private pensions. The BHPS contributes additional current and historic information to help match the FRS and L2.

19. The latest version of the model uses base data derived from the FRS 2011/12, BHPS 1991-2011 and L2 1975/76 – 2011/12. This was the latest data available when PENSIM2 was last updated in early 2015.

20. Beginning with the base data in 2011/12, the model simulates a series of events for each individual in each year. These events include: birth, education, partnership, working, contributing to a private pension, reaching State Pension Age, receiving a state or private pension and, eventually, dying. The likelihood of an event occurring to a particular person is derived from a logistic regression or probability matrix. Broadly speaking alignment is used in two ways within PENSIM2. The first is to ensure the model is consistent with external estimates. For example, fertility and mortality probabilities are aligned to Office of National Statistics population projections, employment rates are aligned to the OBR cohort model of employment. The second situation where alignment is used occurs when we think that the past isn't likely to be representative of the future. For example, automatic enrolment into a workplace pension has led to a substantial increase in the probability of someone contributing to a workplace pension. PENSIM2 deals with this by aligning the numbers of people joining a workplace pension to estimates set out in the automatic enrolment business case and impact assessment.

Time Period

21. We have estimated that the impact of not changing the legislation would extend over a two year period. This is because CEPs are only payable where the member ceases to be a member with less than two years' pensionable service. If their service is less than two years a CEP may be paid. Therefore there may be individuals who have very recently joined a scheme who would not be flagged for a CEP until up to two years from the change of legislation on 6 April 2016, but it is not possible for any impact to extend beyond this.

Method

22. The following steps were taken to estimate the costs saved:

A. IDENTIFY THE TOTAL NUMBER OF ACTIVE DB MEMBERS - Take membership figures published by The Pension Regulator to identify the total number of active participants in contracted out DB pension schemes[2]. This equals around 740k individuals.

B. ESTIMATE THE SUBSET OF (A) EXPECTED TO BE IN SCOPE FOR CEPs - Using PENSIM2 to model the number of active participants expected to have been in DB pension schemes for less than two years on 6 April 2016. This represents the maximum size of the group of members who trustees might be required to make a CEP payment contrary to policy intention (if none of them left the scheme with less than two years' contributions). This totals around 130k individuals.

C. ESTIMATE THE SUBSET OF (B) EXPECTED TO BE AFFECTED BY THE CHANGE – We would expect a significant proportion of the 130k members with less than two years' contributions (B) to leave employment before reaching two years' contributions, who would be required to pay a CEP in the do nothing scenario. We use PENSIM2 to identify the number of members with less than two years' contributions at 6 April 2016 (B) who would also be expected to leave employment with less than two years contributions within two years of April 2016. This group are the people for whom trustees would normally be required to make a CEP, estimated to be around 40k individuals. Therefore the size of the group expected to make a CEP contrary to policy intention in the do nothing scenario is equal to around 90k individuals (130k minus 40k)

D. CALCULATE THE VALUE OF CEPs SAVED UNDER PREFERRED OPTION - Using the average median wage from ASHE[3] and calculating the amount of a CEP based on this wage we estimate an average CEP to be £928[4]. We then multiply this by the number of CEPS we expect to be paid contrary to policy intention (C). For the high estimate we assume 100% compliance, so multiply the average CEP (£928) by the total figure of 130k members with less than two years contribution in a DB scheme (£121m) and subtract this amount from the average CEP multiplied by the estimated number of people who we would expect to be eligible for a CEP payment (£39m) which then gives a high estimate saving of £82m. The compliance assumption is discussed further below in the risks and assumptions section. For the low estimate we apply a 75% compliance assumption in calculating the number of CEPS saved under the preferred option, which gives a lower estimated saving of £62m. The best

[2] http://www.thepensionsregulator.gov.uk/docs/purple-book-scheme-demographics-2015.pdf

[3] http://www.ons.gov.uk/ons/rel/ashe/annual-survey-of-hours-and-earnings/2015-provisional-results/stb-ashe.html#tab-Average-earnings

[4] The CEP is calculated on contracted-out earnings between the Lower Earning Limit and Upper Earning Limit, which are multiplied by the total of the employee and employer contribution reduction for the relevant year (employer rate of 3.4% and employee rate of 1.4% for a 15/16 tax year) then divided by 100.

estimate assumption is then calculated as the midpoint between the high and low figures (£72m – equivalent to a compliance rate of 87.5%).

Table One - Summary of modelled figures

Total number of active DB scheme members (A)	739,200
- of which estimated to have less than 2 years' contributions at 6 April 2016 (B)	130,524
- of which expected to leave the scheme with less than two years' contributions (C)	41,650
Estimated number of CEP payments contrary to policy intention (B - C)	88,875

Table Two - Summary of costings

Estimated savings under preferred option	Low	High	Average
Average CEP (A)	£928	£928	£928
Number of CEP payments in scope (those paid contrary to policy intention) (B)	88,875	88,875	88,875
Compliance Rate (C)	75%	100%	87.50%
CEP Saving (A*B*C)	£61,857,000	£82,476,000	£72,166,500
Admin savings	£2,000,000	£2,000,000	£2,000,000
Total savings (CEP plus admin savings)	**£63,857,000**	**£84,476,000**	**£74,166,500**
Average annual saving (constant prices)	£31,928,500	£42,238,000	£37,083,250

Familiarisation Costs

20. Given that the change in legislation is intended to make the CEP process clearer to pension schemes and administrators we have considered whether there are additional familiarisation costs and concluded that there may be small familiarisation costs for pension scheme staff. The change in legislation means that pension schemes and administrators will be required to read a small amount of new information/guidance detailing those changes. Given the legislation is providing clarification rather than adding in new requirements, we anticipate guidance/information materials to be no more than two pages. To calculate the familiarisation cost we estimate it will take around 5 minutes to read (based on an average reading speed of 300 words per minute) and a further 10 minutes to digest the information. This gives a total of 15 minutes work. The assumed hourly wage rate is £19.10 (including any non-wage costs)[5]. The number of open DB schemes outlined in the Pension Regulator Purple Book[6] (768) is then multiplied by the part hour wage to give a total cost of £4k. This approach is consistent with earlier Impact Assessments. [7]

Risks and assumptions

[5] This estimate is based on the assumption that pension scheme administration is likely to be a higher wage paying profession than general administration. The estimate of £19.10 is based on the gross median hourly rate for an associate professional, which has then been increased by 27% in line with the Green Book to account for non-wage costs. The hourly rate data are taken from the most recent available ASHE, 2015: http://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/bulletins/annualsurveyofhoursandearnings/2015provisionalresults#earnings-by-occupation

[6] http://www.thepensionsregulator.gov.uk/docs/purple-book-scheme-demographics-2015.pdf

[7] Amendments to Pension Schemes Bill (private sector defined benefit transfers) IA. IA no: RPC14-HMT-2212. September 2014. http://www.parliament.uk/documents/impact-assessments/IA14-13A.pdf

21. A key risk in the analysis is the assumed level of compliance. For the purpose of an IA 100% compliance is usually assumed however given the lack of clarity in the legislation and scope for industry confusion there is a risk that assuming 100% compliance will overstate the savings. Therefore we present the analysis using a range with high and low compliance assumptions. In the absence of data on forecast compliance DWP officials held discussions with the Government Actuary Department who agreed that an assumed range of between 75% and 100% is representative of how we would expect the pension industry to behave.

22. There are other risks such as the reliability of the model in estimating labour market transitions which inform the flow of people in and out of pension schemes. However given the source information is from the Labour Force Survey this risk should be minimal. The model also uses externally validated survey data and is cross checked with other published sources for consistency and therefore we would not expect this to have significant effect on the estimates.

23. We have used data provided by HMRC to help assure the outputs from the PENSIM2 modelling. We know from HMRC that the actual amount of CEP payments made in the last financial year (2014/15) totalled around £30m, and that the average CEP payment in that year was £890. This compares to an estimated £38m of the modelled value in 2016/17 assuming 100% compliance and an average CEP payment of £928.

24. The £9m difference can be explained by the following factors:

    a. The £39m modelled figure is a maximum estimate that would represent 100% compliance, HMRC data is based upon actual receipts. If we assumed 75% compliance then this figure would fall to around £29m. This supports the decision to assume less than 100% compliance in the central case best estimate (a central 87.5% compliance rate assumption would equate to £34m).

    b. There may be some further upside discrepancy if there is any lag in CEP payments received after the end of the financial year (i.e. HMRC’s £30m is a lower bound).

    c. Changes to the Lower Earnings Limit and Upper Earnings Limit (used to calculate the estimated value of future CEP payments) between 2014/15 and 2015/16 - the relevant band of (annual) earnings has increased by £468, which means we would expect a small rise in the value of CEP payments made if there was no change in the number of payments.

    d. Actual CEP payments made to HMRC relate only to active DB scheme members who were with their employer for less than two years. This is a much more narrow range of individuals than the population estimated in the PENSIM2 modelling (which includes all active DB members with less than two years’ contributions at a specific point in time). It is plausible that earnings for individuals who move jobs more frequently are lower, and therefore the CEP payments for that group would be lower. The key group of interest for this analysis are those who do not need to pay a CEP under amended legislation.

25. Using the data from HMRC to check modelled outputs therefore increases our confidence in these results.

Direct costs and benefits to business calculations (following OITO methodology)

26. There are two costs associated with not changing the legislation. The first is the payment of the CEP contrary to the policy intention and the second is the administrative costs associated with business processing these payments. The current process is that when a person leaves the employment of a company with a contracted DB pension scheme which they have been contributing to for less than two years then the trustees or managers of the scheme will complete a calculation and send off a payment to HMRC. Both of these costs will be increased as a result of not changing the legislation. We anticipate that both of the costs will be borne by the employer sponsor of the scheme.

27. We estimate that the completion of the relevant form would take around one hour of time for someone at an administrative grade. Using the provisional results from the Annual Survey of Hours and Earnings we can find the median hourly wage which is estimated to be £19.10[8]. This gives us an administrative cost saving of around £2m.

28. There will be small benefits to members: they will not, for example, receive communications about CEPs from the scheme managers; nor will HMRC receive inappropriate communications from scheme managers in relation to CEPs made contrary to the policy intention. Smaller employers will benefit from the clarification of legislation in much the same way as large employers. While there will be a saving to business as a result of not paying certain CEPs which were not the policy intent this represents a loss to the exchequer.

Summary and preferred option with description of implementation plan

29. Current legislation is unclear, it may result in trustees or managers of a DB occupational pension scheme paying a contributions equivalent premium (CEP) contrary to policy intention at the point that contracting-out is abolished (6 April 2016) to a member with less than two years' service, where the member remains a member of the scheme after abolition. This is not what is intended - the policy intention is that a CEP should only be payable in respect of a member who ceases to be a member of the scheme with less than two years' service and should only be required where such a person has no accrued rights in the scheme.

30. The policy objective cannot be achieved through non-legislative options, as requirements are set out in legislation. If the legislation relating to CEPs is not clarified, trustees or managers may pay a CEP contrary to policy intention. The preferred option will provide legislative clarity to trustees or managers to make a CEP payment if the member subsequently leaves the scheme with less than two years' service and no accrued rights.

31. The Department intends to clarify the existing legislation through the Pensions Act 2014 (Contributions Equivalent Premium) (Consequential Provision) and (Savings) (Amendments) and Order 2016 which is expected to come into force on 6 April 2016.

---

[8] This estimate is based on the assumption that pension's administration is likely to be a higher wage paying profession than general administration. The estimate of £19.10 is based on the gross median hourly rate for an associate professional, which has then been increased by 27% in line with the Green Book to account for non-wage costs. The hourly rate data are taken from the most recent available ASHE, 2015: http://www.ons.gov.uk/ons/rel/ashe/annual-survey-of-hours-and-earnings/2015-provisional-results/rft-2.zip

32. The Government wants to ensure that there is smooth end to contracting-out on 6 April 2016. It does not want schemes wasting resources, because of a lack of clarity in the legislation, and paying CEPs contrary to the policy intention.