

The Occupational Pension Schemes (Contracting-out and Modification of Schemes)(Amendment) Regulations 2012

Government response to consultation on draft regulations

February 2012

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1. Introduction

- 1.1 These draft regulations were the subject of public consultation from 15 August to 6 November 2011¹ and relate to:

a proposed amendment to regulation 62(2) of the Occupational Pension Schemes (Contracting-out) Regulations 1996 (SI 1996/1172) – an increase in the percentage rate to be used from 6 April 2012 for revaluation of Guaranteed Minimum Pensions for early leavers where defined benefit pension schemes use the fixed rate method of revaluation;

and

a power to allow defined contribution pension schemes to remove references in their scheme rules to protected rights, following the abolition of defined contribution contracting-out from 6 April 2012.

- 1.2 Also included in those draft regulations, but not part of the consultation, was a technical amendment to Schedule 3 to the Occupational Pension Schemes (Contracting-out) Regulations 1996 (SI 1996/1172) which was inserted by the Occupational Pension Schemes (Contracting-out) Amendment Regulations 2011 (SI 2011/1294), and came into force on 1 October 2011.
- 1.3 There were 18 responses to the consultation. A list of all respondents is provided at Annex A. The Government is very grateful to all those who responded to the consultation. This document outlines the main points made by respondents and provides the Government's response.
- 1.4 The regulations will be available on the UK Legislation website:
<http://www.legislation.gov.uk/uksi/2012>
- 1.5 This document is available on the Department's website:
<http://www.dwp.gov.uk/consultations/2011/>
- 1.6 A paper copy of this document can be obtained from:

Richard Jordan
Department for Work and Pensions
7th Floor
Caxton House
London SW1H 9NA
Email: Richard.jordan1@dwp.gsi.gov.uk

¹ <http://www.dwp.gov.uk/consultations/2011/ops-coms-amd-regs-2011.shtml>

2 Responses to the consultation: increase in the fixed rate revaluation of Guaranteed Minimum Pension for early leavers

We asked: Do you consider that 4.75 per cent should be used as the fixed rate for revaluation of GMPs for early leavers for the period April 2012 to April 2017? If you think this is the wrong percentage, please tell us what you believe the correct percentage should be, and give detailed reasons for your conclusion.

Respondents' comments

- 2.1 Of the eight respondents who commented on the suggested increase (from the current rate of 4%), one organisation agreed with the proposal. Another respondent suggested that as the National Insurance rebate set by the Secretary of State for April 2012-2017 was lower than the Government Actuary had recommended, a lower figure should be used for Guaranteed Minimum Pension (GMP) fixed rate revaluation purposes.
- 2.2 Some respondents questioned the addition of 0.5% for conversion from using an average earnings rate to a fixed rate for revaluation purposes on the basis that historically fixed rate revaluation has, for the majority of the time it has been in use, been greater than revaluation by earnings – the alternative option schemes can choose for revaluing the GMPs of early leavers. Respondents felt that a smaller addition might be more appropriate.
- 2.3 Arguments were put forward for retaining the current rate; others suggested using 4.25% and 4.5% respectively. There was concern that any rate used above 4.5% would significantly increase both administrative expenditure and pension costs at a time when schemes could least afford it. Some respondents thought if the proposed rate was imposed, it could force schemes to close.

Government Response

- 2.4 When considering the amount of the reduced (rebate) rate of Class 1 National Insurance Contributions for members of salary related contracted-out schemes to be used from 6 April 2012, the Government Actuary presented three options in his report² – a best estimate basis, a typical funding basis, and a gilts basis.

²http://www.gad.gov.uk/Documents/Pensions%20Policy%20&%20Regulation/Contracting%20Out/Report_to_parliament_on_the_2011_review_of_contracting-out_terms.pdf

The Secretary of State chose to use the best estimate approach. The Government Actuary advised that the 4.75% revaluation figure he proposed would be appropriate where the Secretary of State chose a rebate rate within the best estimate range. As the 4.8% National Insurance rebate rate determined by the Secretary of State is set at less than 6%³, it does not follow that the rate for fixed rate revaluation should be lower than the figure that was recommended.

- 2.5 In section 15 of his report, the Government Actuary proposed a fixed rate revaluation rate of 4.75% compound, based on assumed national average earnings growth of 4.25%, with the addition of 0.5%. This 0.5% addition is to compensate for the conversion of a variable rate of revaluation, which may be subject to unexpectedly high increases, to a fixed rate.
- 2.6 In recognition of the arguments put forward in support of rates lower than 4.75%, the Government Actuary's Department (GAD) was provided with respondents' comments and asked to review the proposed rate of 4.75% in view of experience since January 2011, when the Government Actuary's report was finalised. GAD concluded that although there was a slight shift in some components of the underlying assumptions, these broadly cancelled each other out, with no change to the proposed rate of 4.75%. By way of comparison, GAD pointed out that the proposed rate is similar to the Office for Budget Responsibility's (OBR) current long term national earnings growth assumption of 4.7%, although the OBR does not include an addition of 0.5% which the Government Actuary included for this purpose (as mentioned in paragraph 2.5). The relevant extract from GAD's advice is at Annex B.
- 2.7 Turning to the 0.5% addition, whilst it is true that historically fixed rate revaluation rates have exceeded (for the majority of the time) revaluation by earnings, it is not the case that this will necessarily continue. By electing for fixed rate revaluation, schemes have received protection against the risk of unexpectedly high earnings growth. The Government therefore does not consider the 0.5% addition to be unreasonable.
- 2.8 Viewed in isolation, any increase in the revaluation rate will increase scheme costs relative to the current rate, but the Government believes that pension provision is important, and that it is appropriate that accrued amounts for future pensioners are protected on a basis consistent with that on which the rebate was determined. We have not been provided with any evidence to suggest that schemes would close because of this increase in the revaluation rate.

³ see paragraph 15.7:

[http://www.gad.gov.uk/Documents/Pensions%20Policy%20&%20Regulation/Contracting%20Out/Rep to parliament on the 2011 review of contracting-out terms.pdf](http://www.gad.gov.uk/Documents/Pensions%20Policy%20&%20Regulation/Contracting%20Out/Rep%20to%20parliament%20on%20the%202011%20review%20of%20contracting-out%20terms.pdf)

3. Responses to the consultation: modification of scheme rules for defined contribution schemes

We asked: Do you consider that the statutory power to modify scheme rules, as drafted, would enable trustees to alter their scheme rules to remove the requirements of the protected rights legislation in order to extend the benefits of defined contribution contracting-out abolition to their members?

Respondents' comments

Respondents to this section of the draft regulations commented on a range of issues, which have been broadly grouped under the following headings:

Statutory override

- 3.1 Four organisations considered the draft regulations would allow schemes to modify their rules to remove references to protected rights from scheme rules. However, seven organisations called for a wider statutory override in respect of protected rights, that is, a provision which would have effect so as to automatically remove references to protected right in scheme rules.

Deadline in regulations

- 3.2 Some respondents queried the length of time allowed for schemes to change their rules, and whether trustees would be able to pass more than one resolution during the timescale. They considered that three years would not be long enough for schemes to complete the process. Some suggested that there need not be a deadline at all, as the changes were being made to reflect legislation. Two respondents posed questions relating to the consequences of schemes not being able to make the change within the timescale, or perhaps because the trustees were no longer contactable. Another respondent requested that the regulations be in force by December 2011.

Existing legislation

- 3.3 Several respondents queried the interaction of existing legislation with the proposed regulations. They sought clarification relating to: section 31 of the Pension Schemes Act 1993 (all contributions deriving from the rebate must be applied to provide money purchase benefits); section 67 of the Pensions Act 1995 (subsisting rights provisions); section 259 of the Pensions Act 2004 and regulations 8 and 10 of the regulation 10(1) of the Occupational and Personal Pension Schemes (Consultation by Employers and Miscellaneous Amendment) Regulations 2006 (SI 2006/349) (employer consultation requirements). Concern was raised about the issue of short service lump sum refunds and how these

would be treated following the abolition of contracting out on a defined contribution basis.

Other issues

- 3.4 Some respondents raised the issue of underpins. There were also queries about the range of the power being given, and the impact of the new regulations on the administration of schemes. One respondent questioned whether the disclosure requirement following abolition of defined contribution contracting out could be effectively achieved, given the timing of these regulations. A few respondents suggested alternative wording to clarify the policy intention in the draft regulations.

Government response

Statutory override

- 3.5 The intention of the proposed regulations is to allow a trust-based scheme to remove the protected rights rules which apply to the money purchase benefits or underpins where the trustees may not have the powers to make those changes to the scheme rules. We are aware that some schemes would prefer a wider override which would have the effect of automatically removing references to protected rights in scheme rules. However, this would be neither possible nor practical as such a change would require a new Act of Parliament, which cannot be achieved before April 2012 when contracting out on a defined contribution benefit basis ends. Furthermore, since schemes vary so much in their design, even if provision was made through primary legislation, it would not guarantee that every scheme would be able to take advantage of it without administrative complications. For example, some schemes may wish to keep part of their protected rights rules in place; a wider statutory override would make this impossible. This package of regulations allows flexibility, giving schemes the option to use them if they are required.

Deadline in regulations

- 3.6 The Government seeks to ensure, where necessary, all new regulations include either a date for review or a date when the particular regulation will cease to be effective. Draft regulation 7A(1) stated that trustees may pass a resolution before 6 April 2015 to effect removing all or part of a scheme rule which relates to protected rights. We have considered the reasons put forward for requests for an extension of the deadline, and have changed the deadline to 5 April 2018. This will ensure trustees of schemes that wish to use this power have time to do so.
- 3.7 As long as the changes proposed to the scheme rules are within the scope of the power in these draft regulations, trustees may pass more than one resolution within the timescale. If trustees are unable to pass a resolution before the date in the regulations, they will have to make the changes under their own amendment powers, which may be subject to their own consultation requirements and those set out in section 67 of the Pensions Act 1995. It is not

possible to lay these regulations before 6 December 2011; the intention is that these regulations will come into force at the same time as the legislation completing the abolition of defined contribution contracting out.

Existing legislation

- 3.8 We acknowledge that there is scope for clarifying the effect of the modification power in relation to section 31 of the Pension Schemes Act 1993, and we have re-drafted the text of the regulations to ensure clarity of intention that once protected rights rules are removed, former protected rights benefits will become ordinary money purchase benefits.
- 3.9 We consider that the majority of rule changes that will be made using this power will fall outside the requirements for employer consultation under the “listed changes” provisions (section 259 of the Pensions Act 2004). The modification power provided by these regulations is an enabling power for schemes; its use is not mandatory. Therefore we consider that the exemptions set out in regulation 10 of the Occupational and Personal Pension Schemes (Consultation by Employers and Miscellaneous Amendment) Regulations 2006 do not apply to any changes made using the power. If scheme sponsors wish to make other changes to scheme rules as a result of the abolition of contracting out on a defined contribution basis which are outside the scope of this power (for instance increasing or decreasing employer contribution rates), those may require consultation as set out in that section and regulations made under it.
- 3.10 We are aware of the issue of short service lump sum refunds. As these are matters involving tax legislation, we have referred them to Her Majesty’s Revenue and Customs (HMRC) who will identify whether there are consequential amendments needed to tax legislation as a result of abolition. If changes are deemed necessary, HMRC will be taking these forward at the appropriate time.

Other issues

- 3.11 Trustees must always act in the scheme members’ best interests, and that must be carried through when considering the changes allowed by these draft regulations. Money purchase benefits will remain in the scheme, including money purchase underpins, which were formerly protected rights underpins. The power allows the term “protected rights” to be removed from the scheme’s rules in relation to money purchase benefits, but the money purchase benefits themselves must remain.
- 3.12 Where a scheme has defined benefit based underpins, that scheme is outside the scope of the proposed regulations and will not be affected. Where a scheme has not set out separate protected rights, all money purchase rights will be treated as protected rights under section 10 of the Pension Schemes Act 1993. These schemes can use the power to amend the rules which apply to all benefits under the scheme if they relate to the statutory provisions for protected rights. The regulations do not apply to contract-based schemes or insurance / annuity policies (e.g. section 32 buy-outs).

- 3.13 Trustees may not make a resolution to amend scheme rules to remove protected rights references before 6 April 2012. There will be a period of time during which schemes will have to be administered according to existing scheme rules after 6 April 2012, even though special provision for protected rights for formerly contracted-out defined contribution schemes will no longer be required by legislation after that date. However, trustees could make a resolution after 6 April 2012 which has retrospective effect back to that date.
- 3.14 The disclosure statement, as required by regulation 5(7) of, and Schedule 2 to, the Occupational Pension Schemes (Disclosure of Information) Regulations 1996 (SI 1996/1655) and regulation 5(9) of, and Schedule 2 to the Personal Pension Schemes (Disclosure of Information) Regulations 1987 (SI 1987/1110) (as amended by SI 2011/1245⁴ and SI 2011/1246⁵) following the abolition of defined contribution contracting out will have to be completed within the set timescale. Where trustees need to amend the scheme rules to remove protected rights terminology but have yet to decide on a course of action, this should be explained in that statement.
- 3.15 We have amended the wording of these regulations where necessary to ensure the intention is clear.

4. Next Steps

- 4.1 The Government plans to make amending regulations which will come into force on 6 April 2012.

⁴ <http://www.legislation.gov.uk/ukxi/2011/1245/contents/made> "The Pensions Act 2007 (Abolition of Contracting-out for Defined Pension Contribution Schemes)(Consequential Amendments) Regulations 2011"

⁵ <http://www.legislation.gov.uk/ukxi/2011/1246/contents/made> "The Pensions Act 2008 (Abolition of Protected Rights)(Consequential Amendments) Order 2011"

Annex A: List of respondents to public consultation

Actuarial Profession
AonHewitt
Association of Pensions Lawyers
Aviva
Eversheds LLP
Law Society of Scotland
Legal & General Assurance Society Ltd
Mercer
Mr C Scott
National Association of Pension Funds
Pensions Management Institute
Prudential
Sackers LLP
Scottish Life
Society of Pension Consultants
Standard Life
Towers Watson
Zurich Financial Services

Annex B: Extract from the Government Actuary's Department's letter dated 20 December 2011

"If the Secretary of State wishes to retain the practice of setting the fixed revaluation rate by reference to the assumed rate of growth in average earnings plus $\frac{1}{2}\%$, experience since January 2011 does not suggest any reasons to amend materially the proposed rate of $4\frac{3}{4}\%$. By way of comparison, the proposed fixed revaluation rate of $4\frac{3}{4}\%$ (including the $\frac{1}{2}\%$ addition) is similar to the OBR's long-term earnings growth assumption of 4.7%, although the derivations differ."