Title: Abolition of Short Service Refunds **IA No:** DWP0023a **Lead department or agency:** DWP **Other departments or agencies:**	**Impact Assessment (IA)** **Date: November 2014** **Stage: Enactment (Commencement)** **Source of intervention:** Domestic **Type of measure: Secondary Legislation** **Contact for enquiries**: Jane Ball, 0207 449 5434

Summary: Intervention and Options

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, Two-Out?**	**Measure qualifies as**
£33.75m	-£119.80m	£10.59m	YES	IN

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

In an occupational pension scheme, members who leave the scheme within two years of joining can be offered a refund of their contributions or a cash transfer to another scheme. If the member does not actively choose a transfer they can be defaulted into receiving a refund of their contributions. Employer's contributions remain in the scheme, allowing them to offset future contribution or administration costs. Individuals therefore lose their pension savings by withdrawing them from the scheme, and lose the value of their employer's contributions. This is contrary to the policy objective to get the vast majority of working people saving in a pension. Short service refunds are not possible in workplace personal pension schemes, so there is a disparity in treatment of members depending on the type of scheme an employer chooses for their employees.

What are the policy objectives and the intended effects?

The Government's policy objective is to promote continuous pension saving in order to promote good retirement incomes for individuals. Automatic enrolment will bring millions of individuals into pension saving and help them build a retirement income, but the regulatory framework needs to support this for all workers, including those who leave employment within two years. Short service rules for occupational schemes give employers a strong incentive to offer refunds, at a cost to short term workers who could automatically receive a refund of their contributions – and lose employer and state contributions – when they move jobs. The effect of the changes will mean that these individuals retain their, their employers', and the state's contributions in a pension scheme.

What policy options have been considered, including any alternatives to regulation?

Existing legislation means that occupational schemes can choose whether to offer short service refunds (SSRs) – any measure which removes the option of refunding members' contributions would therefore have to be legislative. The previous Impact Assessment in 2011 covered a range of options from doing nothing, changing the default action to make the refund an active choice, and abolishing SSRs. The preferred option was to abolish SSRs in 2014, as a way of increasing pension savings and limiting the market distortions created by different rules in occupational and workplace personal pension schemes.

Since the publication of the original impact assessment in December 2011, Parliament has passed legislation to abolish SSRs through section 36 of the Pensions Act 2014. This provision is yet to be commenced. It withdraws the facility for money purchase occupational pension schemes to offer refunds of member contributions after the member has been in the scheme for more than 30 days. In order to give schemes time to prepare for the new legislation we have decided to delay implementation until October 2015.

This impact assessment therefore considers 2 options: do nothing, and abolish SSRs in money purchase occupational schemes from October 2015, but allow refunds of member contributions for the first 30 days.

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: 06/11/14

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	

Summary: Analysis & Evidence

Policy Option 1

Description: Do nothing -

FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2015	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 0	**High:** 0	**Best Estimate: 0**

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

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

N/A

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

N/A

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

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

N/A

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

N/A

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

With no abolition, short service refunds are assumed to continue for money purchase occupational schemes with future volumes set out in paragraphs 23 – 28. As the average amounts refunded are assumed to be fairly low (see paragraphs 31 – 33) it is assumed that they are often spent fairly quickly and any investment growth achieved from them is negligible.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 0	**Benefits:** 0	**Net:** 0	N/A	N/A

Summary: Analysis & Evidence — Policy Option 2

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2015	Time Period Years 10	Net Benefit (Present Value (PV)) (£m) Low:	High:	Best Estimate: 33.75

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low				
High				
Best Estimate	0		30.2	**250.2**

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

The costs are made up of short-term costs to employees, employers and the state from no longer receiving refunds of their contributions, and administrative costs to employers associated with maintain a dormant pension pot. The average annual costs over 10 years from 2015 in 2014 constant prices are estimated as:

- Employer cost of no longer receiving refund - £14.3 million
- Employee cost of no longer receiving refund - £10.9 million
- Cost to State from no longer receiving tax paid on refund - £2.5 million
- Administrative cost to schemes of maintaining dormant pot - £2.5 million (of which half are assumed to fall to employers rather than the scheme members)

Other key non-monetised costs by 'main affected groups

N/A

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant	Total Benefit (Present Value)
Low				
High				
Best Estimate	0		34.4	**284.0**

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

The benefits are made up of long-term benefits to employees due to having pension rights which they otherwise would not have accrued, plus benefits to employers from the charges received on the pension, and administrative savings for employers from no longer having to process short service refunds. The average annual benefits over 10 years from 2015 in 2014 constant prices are estimated as:

- Employee pension rights - £32.2 million
- Administrative savings to scheme from no longer processing refund - £1.1 million (of which half are assumed to benefit employers rather than scheme members)
- Charges received by scheme in respect of dormant pots - £1.1 million (of which half are assumed to benefit employers rather than scheme members)

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

N/A

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

Future volumes of short service refunds that would have occurred are calculated on the basis of the current ratio of short service refunds to new entrants to money purchase occupational schemes. An underlying assumption is that there are no material changes to the labour market in the future which would result in higher or lower job churn. Sensitivities around the volumes have been tested in paragraphs 44 – 49.

The administrative costs and benefits to schemes will either fall to employers or scheme members depending on the governance and funding of each scheme. Following engagement with the Pensions Regulator, it is assumed that the costs and benefits fall equally between employers and scheme members as discussed in paragraphs 40-41.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 11.4	**Benefits:** 0.8	**Net:** 10.6	Yes	In

Background

1. Automatic enrolment has brought millions of people into pensions saving and it is estimated that pension saving will increase by £11bn a year (within a range of £8 billion to £12 billion)[1]. Government wants to ensure that these savings stay within pension savings. Abolishing short service refunds for money purchase occupational schemes will mean that members' contributions stay invested in pension schemes and that they will not lose the employer and state contributions to their pension saving.

2. To promote consistent pension saving there has to be a similarity between the treatment of members in all money purchase pensions. A 2011 Call for Evidence showed that short service refunds were a key regulatory difference between occupational and workplace personal pensions and would be a key factor amongst a range of factors influencing employer's scheme choice. With the advent of automatic enrolment the availability of short service refunds is particularly significant for larger employers, especially those with high staff turn-over, allowing them to manage early leavers and retain their contributions within the scheme.

3. The Government concluded that there was no compelling reason to retain short service refunds. There were some concerns that abolishing SSRs would lead to an increase in small dormant pots that would have to be administered by schemes. However, this is mitigated by the Government's plans for the automatic transfer of small pension pots as the member moves jobs. The Pensions Act 2014 sets the legislative framework for this system of automatic transfers and we are currently working with stakeholders to develop the details of the implementation model.

4. The Government announced the abolition of short service refunds in the consultation on *Improving transfers and dealing with small pension pots* in December 2011, when the original Impact Assessment was published. Parliament subsequently passed legislation in the Pensions Act 2014 which removes the facility for schemes to offer short service refunds. The Act removes the option for occupational money purchase schemes to offer refunds after the member has been in the scheme for more than 30 days. This creates parity between savers in occupational and workplace personal pension schemes.

5. The Government intends to abolish short service refunds, by commencing Section 36 of the Pensions Act 2014, but wants to provide sufficient notice so that affected schemes have time to prepare. In order to give schemes time to make any necessary alterations to scheme rules or systems we now intend to bring the provision into force in October 2015, later than envisioned in the original Impact Assessment.

Rationale for intervention

6. As at the end of September 2014, 4.75 million people have already been automatically enrolled into a workplace pension[2], with just 9-10% choosing to opt out[3]. An estimated 10

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[1] DWP (2012), Workplace Pension Reforms: Baseline Evaluation Report. 2012/13 earnings terms.

[2] The Pensions Regulator (September 2014), Automatic Enrolment Registration Report.

million people will be eligible for automatic enrolment into a workplace pension scheme by 2018[4], of which 9 million will be newly saving or saving more with a range of 6-9 million[5].

7. However, current rules on early leavers in occupational pension schemes risk undermining this goal. Short service refund rules give individuals who leave an occupational pension scheme with at least 3 months, but less than 2 years, of pensionable service the right to, (a.) the right to a refund of their contributions (a short service refund), or (b.) a cash transfer sum.

8. A transfer into another pension scheme includes both the member's contributions and the employer's contribution, but if the member takes a short service refund the employer's contributions remain in the scheme and can be used by employers to offset future pension contribution costs or cover administrative costs. Research[6] suggests that the majority of members opt for a short service refund rather than a transfer into a different scheme. Where members do not make an active choice, in most cases, schemes will give a refund as they are unable to process a transfer if the member has not informed them where to transfer it to. However, not all money purchase occupational pension schemes offer SSRs. For example, we know that NEST does not allow SSRs for their schemes[7]. Workplace personal pensions cannot offer these refunds.

9. Currently around 20,000 short service refunds are taken from money purchase occupational pension schemes each year[8]. Without changes to the regulatory regime, short service refunds will continue, and more individuals will miss out on opportunities to increase their pension savings, and lose their previous employer and state contributions.

Case Study[9]

Mark earns £15,000 per year. He joins his employer's money purchase occupational pension scheme and contributes a total of 8%, made up of 4% from Mark, 3% from the employer, and 1% in tax relief. He leaves his job in just before reaching 2 years in the scheme.

If short service refunds were to continue, and Mark is defaulted into receiving a refund, he would lose his pension rights and instead receive back his contributions of around £960 (on which he would pay tax at the basic 20% rate) plus around £130 due to the fund growth net of charges paid on the pot (which would also be taxed). This gives Mark a total refund of around £870 after tax, with the State receiving around £220 in tax. Meanwhile, the employer would receive their contributions back at around £580.

Alternatively, if short service refunds were abolished before he joined the scheme, Mark would retain his pension rights and the employer would continue to maintain his dormant pot until normal retirement age or until requested to transfer it to another scheme. At the point he leaves

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3 DWP (2014) Employers Pension Provision survey 2013: preliminary findings

4 DWP (2013), Review of the automatic enrolment earnings trigger and qualifying earnings band for 2014/15: supporting analysis.

5 DWP annual report and accounts

6 "The use of vesting rules and default options in occupational pension schemes", DWP Research Report 725

7 https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/NEST-Order-and-Rules,PDF.pdf

8 Occupational Pension Scheme Survey, 2013

9 Case study is illustrative based on DWP modelling assuming 5% real fund growth, 0.75% Annual Management Charge 2% inflation and 4% earnings growth.

the scheme his pot would be worth around £1,670. If he then accessed it 10 years later, allowing for investment growth and charges, it would be worth around £3,000 in nominal terms. Or if he accessed it 25 years later, it would be worth roughly £7,500 in nominal terms.

Policy objectives

10. Changing short service refunds fulfils a number of policy objectives:
    a. complementing the aims of automatic enrolment by facilitating more people saving more for their retirement;
    b. ensuring that individuals automatically enrolled into occupational schemes will be able to continually build their pension savings and benefit from their employer's contribution and the state contribution (which they would forego if they took a refund);
    c. minimising market distortions caused by the application of different regulatory frameworks to otherwise similar pension products (e.g. Master Trusts and Group Personal Pensions).

Description of options

11. Existing legislation means that occupational schemes can choose whether to offer short service refunds. The preservation of benefit provisions in the Pensions Schemes Act 1993 mean that schemes have the option either to offer short service refunds or to vest a member's rights prior to two years. Any measure to remove the option of refunding members' contributions therefore has to be legislative.

12. The previous impact assessment[10] covered 5 options:
    - Do nothing.
    - Change the default action – make the refund an active choice, applicable from 2014.
    - Change the default action – make the refund an active choice, applicable from 2017.
    - Abolish short service refunds – schemes would no longer be able to offer short service refunds, applicable from 2014.
    - Abolish short service refunds – schemes would no longer be able to offer short service refunds, applicable from 2017.

13. The preferred option was to abolish short service refunds in 2014, as a way of increasing pension savings and limiting the distortions in the market created by different rules in occupational and workplace personal pension schemes.

14. Since the publication of the original impact assessment in December 2011, Parliament has passed legislation abolishing short service refunds for occupational money purchase pension schemes. Section 36 of the Pensions Act 2014 withdraws the facility for occupational money purchase pension schemes to offer refunds after the member has been in the scheme for more than 30 days. However, Section 36 is yet to be commenced (i.e. the provision is not yet in force). That leaves two options to be considered in this impact assessment.

[10] Short Service Refunds Impact Assessment, DWP, December 2011

Option 1: Maintaining the status quo (Do nothing) so short service refunds continue (do not commence Section 36)

15. Our first option is to do nothing and retain existing short service refund rules. This option would allow schemes to continue to refund members' contributions when they leave within 2 years, retaining employer's contributions within the scheme. This option serves as a baseline option for assessing the impact of the other options considered. For the purposes of the IA, this option therefore has zero costs and benefits (relative to itself).

Option 2: Abolish short service refunds from October 2015. Allow schemes to offer a refund of member contributions for the first 30 days (commence Section 36)

16. When commenced, Section 36 of the Pensions Act 2014 will withdraw the facility to make short service refunds from money purchase occupational pension schemes. These schemes will be able to give refunds of member contributions within 30 days, ensuring parity between members of occupational and workplace personal pension schemes.

17. The Government announced its intention to abolish short service refunds in December 2011, and passed legislation to do so in 2014. A number of schemes have therefore already stopped offering short service refunds (because the currently legislation is permissive). For schemes that do need to make changes to remove short service refunds, we want to give them time to do this and therefore aim to commence the legislation, through a commencement order, which makes clear that short service refunds will be banned from October 2015.

Preferred option

18. The preferred option is Option 2: abolish short service refunds from October 2015, while allowing schemes to offer a refund of member contributions for the first 30 days. If short service refunds were to continue, it would mean that an increasing number of people would miss out on the opportunities of pension saving and retain the market distortion created by different rules for occupational and workplace personal pension schemes.

19. The abolition of short service refunds could lead to an increase in the number of small dormant pension pots. However, the majority of the additional dormant pots resulting from this change will be worth significantly less than £10,000 and will therefore be subject to the automatic transfer requirements. The savings for this are included in the Automatic Transfers IA[11] published in July 2012.

[11] Small Pots and Automatic Transfers Impact Assessment, DWP, July 2012

Costs and benefits

20. Abolishing SSRs will create three types of costs and benefits:

- Long term benefits to the employee in retaining the employer and state contributions to their pension pot and the investment growth delivered by leaving their pension pot invested rather than taking a cash refund of their contributions.

- The associated short term costs to the employee, employer and state where money in the member's pension pot will be retained in the employee's pension rather than transferred to the employee and employer via refunds, and the state via tax paid on employee's refund.

- Administration costs and benefits to pension schemes. There will be a cost to schemes in maintaining the dormant pot for as long as it remains in the scheme, net of charges paid on the pot over the same period. There will also be a saving from no longer having to process the refund. In some cases these costs will be partly met by employers rather than wholly by schemes.

21. To calculate the costs and benefits we first estimate the number of short service refunds that would have occurred in the future. This is based on information about past volumes and projections of the number of new entrants to occupational money schemes over the next few years, including during the roll out of Automatic Enrolment.

22. The costs and benefits associated with the refund are estimated based on current SSR amounts. The administrative costs are calculated using a 10 year time horizon using assumptions from industry on the average costs of processing refunds, maintaining pots, and average levels of charges. These elements of the costing are described in more detail below and summarised in Table 1. A breakdown of the costs and benefits in each year is provided in the Annex.

Table 1: Summary description of monetised costs and benefits

	Schemes	Employers	Employees	State
Option 2: Abolish SSRs	Cost from no longer getting refunds which they can reinvest into the scheme: **£14.3m** Admin cost of having to maintain the dormant pot: **£2.5m** Admin saving from receiving charges paid on dormant pot: **£1.1m** Admin saving from no longer having to process refund: **£1.1m**	The extent to which employers are affected by the costs and benefits in the 'schemes' column will depend on the extent to which they choose to subsidise the administration costs of the scheme.	Cost from no longer receiving refund: **£10.9m** Benefit from having pension rights retained: **£32.2m**	Cost from no longer receiving tax paid on refund by employee: **£2.5m**

Note: Amounts in the table are average annual costs and benefits over 10 (calendar) years from 2015 expressed in 2014 prices.

Number of Short Service Refunds in the future

23. There is no existing forecast of SSRs but we can derive future volumes from a combination of sources, including past data on the number of SSRs. There are two sources of data on past volumes of SSRs:

- The Occupational Pension Schemes Survey reports the number of SSRs for the last 4 years by type of scheme with levels typically around 20,000 a year for private sector occupational money purchase schemes as shown in Table 2.

- HMRC also collects information on the number of SSRs on which tax has been paid. This information does not split the volumes by type of pension (money purchase / defined benefit), but these can be derived using the proportions from the Occupational Pension Schemes Survey data.

Table 2: Number of members leaving pensionable service with a short service refund: by sector, 2010-2013

	Private Sector		**Public Sector**	**Grand Total**
	DB	**Money Purchase**	**DB**	**All**
2013	10,000	20,000	40,000	70,000
2012	20,000	10,000	50,000	80,000
2011	10,000	20,000	60,000	90,000
2010	20,000	20,000	60,000	100,000

Source: OPSS, 2010-2013[12]

24. From either of these data sources we can calculate a ratio of SSRs to new entrants to money purchase occupational schemes for recent years[13]. For the purposes of this assessment the HMRC data is used as it gives a more stable ratio of SSRs to new entrants over a longer time period. It gives a ratio of around 4 SSRs to every 100 new entrants in recent years.

25. We can predict the number of new entrants to occupational money purchase schemes in the future by using the DWP's Pensim2 model[14]. This is a dynamic simulation model, an output of which is to show the projected number of new entrants including over the period when automatic enrolment is rolled out. This shows the number of new entrants to occupational money purchase schemes[15] rising from around 0.5 million per year in 2011/12, rising to around 2.0 million by 2018/19 once automatic enrolment is rolled out

26. As NEST does not allow SSRs as part of their scheme rules, we remove new entrants assumed to join NEST from the Pensim2 volumes. This is estimated by a combination of

[12] Occupational Pension Schemes Survey, 2010-2013, ONS. Excludes schemes with less than 12 members, estimates rounded to the nearest 1,000.

[13] The number of new entrants to money purchase scheme in recent years comes from DWP's Pensim2 model (see paragraph 25 for more details)

[14] Pensim2 is a dynamic micro-simulation model based on a sample of synthetic individuals, reflecting the characteristics of the British population. It is used to model future pension incomes and produces results which describe the population as a whole or subgroups.

[15] As SSRs are not available in workplace personal pension schemes, we ignore new entrants to these schemes for the purpose of the costing.

Pensim2 breakdowns and the DWP's modelling of Automatic Enrolment[16]. There may also be other master trusts that do not allow SSRs. However, this level of information is not disclosed so for the purposes of the costing we assume other master trusts do allow SSRs, so not to understate the potential impacts. Therefore, we are left with a projection of new entrants to occupational money purchase schemes which excludes those in NEST.

27. The next step is to apply the previously calculated ratio of SSRs to new entrants, to the predicted number of new entrants of money purchase occupational schemes, excluding NEST. This results in a projection of SSR volumes in the future as shown in table 2 below. It shows that between 2013 and 2015 we expect a large increase in SSRs as a large number of people are automatically enrolled into their employer's scheme for the first time, and often into existing or new occupational money purchase schemes.

28. However towards the latter end of automatic enrolment roll out, small and micro employers are assumed to predominantly choose workplace personal pension schemes or master trust schemes including NEST, which means new entrants to other occupational money purchase schemes make up a lower proportion of the total. This is the cause of the reduction in SSRs to around 27,000 per year from 2017 onwards.

Table 2: Projection of number of Short Service Refunds for DC trust-based schemes

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
28,000	48,000	36,500	30,500	28,000	27,000	27,500	27,500	27,000	27,000

Number of Short Service Refunds that will be abolished

29. Under the policy option, SSRs will be abolished for new entrants from October 2015. This means that anyone already in a scheme before October 2015 who leaves within 2 years will still be able to receive an SSR. But from October 2015 the numbers will gradually reduce, slowly at first and then more quickly until by October 2017 there will be no further SSRs.

30. The number of SSRs during this transition period has been estimated by considering typical flows from employment each quarter based on analysis of the Labour Force Survey.[17] This analysis has been applied to the projection of SSRs to determine the proportion of SSRs that would still occur for employees in the scheme prior to 2015. This gives the adjusted projection below for the number of SSRs that will be abolished.

Table 3: Projection of number of abolished Short Service Refunds for DC trust-based schemes

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
0	0	500	9,500	26,000	27,000	27,500	27,500	27,000	27,000

Amounts refunded now and in the future

31. The amount refunded is determined by how much has been contributed by the employer and employee by the time the employee leaves the scheme. The employee will then pay

[16] DWP (2012), Workplace Pension Reforms: digest of key analysis - July 2012.

[17] Labour Market Flows, August 2014 (Experimental Statistics)

tax on their refund, usually at the basic 20% rate, which essentially means the state also receives back the tax relief on the employee's pension contributions[18].

32. We calculate the size of the refunds by considering the amount of tax paid on SSRs and the average ratio of employee to employer contributions. HMRC collects data on tax paid on all SSRs (including those relating to defined benefit as well as money purchase schemes). This shows that on average over the last year the state has received around £85 from each SSR, and that this has fallen over time. It shows that the vast majority of people receiving SSRs pay at the basic 20% rate of tax. Dividing the tax paid by the rate of tax (mostly 20%) gives the average refund back to the employee at around £415. To calculate the average refund to the employer we use the ratio of employee to employer contribution rates, as recorded in the OPSS. The OPSS shows for private sector trust-based schemes the average contribution rates are 6.1% from employers and 2.9% from employees[19]. This gives a ratio of 2.1 units of employer contribution to every unit of employee contribution, which therefore gives an average employer refund of £870 (2.1 x £415) and an average total pot size of around £1,375.

33. These estimated amounts are likely to overstate the size of refunds as the underlying data includes refunds made from Defined Benefit schemes, which tend to be associated with high contribution rates. In addition, we expect that many of the new savers who would otherwise receive a SSR will be paying lower than average contributions because they will have been enrolled as a result of automatic enrolment, and are therefore more likely to pay the minimum automatic enrolment contribution rates[20]. A reduction in average contributions will reduce the level of average refunds. Since not all new entrants will pay minimum contributions we have assumed the average contributions to be halfway between what they are currently and what they would be under minimum automatic enrolment contributions. This gives average refunds of £650 to the employer, £495 to the employee and £115 to the State, with a total pot size of £1,260.

<u>Short-term refund Costs</u>

34. The short term costs are calculated by multiplying the number of SSRs that will be abolished in each year with the average amounts of refunds. This gives an average annual cost over 10 calendar years from 2015 of around £14.3 million to employers, £10.9 million to employees and £2.5 million to the state (expressed in constant 2014 prices).

<u>Increased pension rights</u>

35. The key benefit from the abolition of SSRs will be increased pension rights for the employee. The pension rights will initially be equal to the size of the pot that would have otherwise been refunded. But over time this will increase in line with fund growth, net of charges paid. To monetise this benefit, we start with the average pot size of around

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[18] The amount of tax deducted from a short service refund lump sum is 20% in respect of the first £20,000 of the payment and 50% in respect of the remainder of the payment over £20,000. If there is an amount of the refund before tax that is greater than the amount of the contributions you paid (i.e. representing investment growth) then this should be accounted for it on a self-assessment tax return.

[19] OPSS, Figure 8, 2013

[20] The minimum contribution rates will be 4% from the employee, 3% from the employer and 1% from tax relief when automatic enrolment is fully rolled out by October 2018.

£1,260 (see paragraph 33) and apply an annual real growth rate of 5%[21] and an annual management charge of 0.75%[22]. The pot will continue to grow until the member reaches the normal retirement age and converts it to a retirement income, but for this assessment we consider the benefit of having the pension rights in each year and not the retirement income that may eventually be achieved from it. This means the benefit is £1,260 per member in the first year followed by an average growth of around £60 per year per member in constant 2014/15 terms. Applying this to the number of abolished SSRs gives an average annual benefit of around £32.2 million in constant 2014 terms over the 10 calendar years from 2015 which far outweighs the short term costs to employees from not receiving the refund.

Admin costs of maintaining dormant pots

36. Industry sources have previously stated the cost of maintaining a dormant pot is around £25 per year[23]. This is the gross cost, some or all of which may be covered by the charges paid to look after the pot. The period of time that the pot remains dormant for will depend on the age of the member, but for the purpose of this assessment we look over a 10 year evaluation horizon and assume a £25 cost per pot in each year. Applying this to the number of abolished SSRs gives an average annual costs to employers / schemes of around £2.5 million in constant 2014 terms over the 10 calendar years from 2015.

Charges received

37. To calculate the charges that will be received to help with the cost of maintaining the pot, we use the same method and assumptions used to calculate the employee pension rights. So based on an average pot of £1,260 and a 0.75% Annual Management Charge, this gives an average annual cost of around £12 per pot over a 10 year time horizon. Applying this to the number of abolished SSRs gives an average annual benefit to employers / schemes of around £1.1 million in constant 2014 terms over the 10 calendar years from 2015.

Admin savings from not having to process the refund

38. The cost of processing the refund is assumed to be around £50 per SSR. This estimate is based on the typical admin costs of processing a transfer as the processes involved are assumed to be broadly analogous[24]. Applying this to the number of SSRs that will be abolished gives average annual administrative savings for employers / schemes of £1.1 million in constant 2014 terms over the 10 calendar years from 2015.

Transition and familiarisation costs

39. We anticipate that transition and familiarisation costs will be negligible, particularly as the policy was announced in 2011 and primary legislation laid in 2014, so employers and

[21] A real growth rate of 5% is consistent with previous analysis, for example,DWP's Charges in Qualifying Pension Schemes Impact Assessment, 2014

[22] Average AMC for trust-based schemes, based on DWP Landscape and Charges Survey, 2013

[23] Based on informal engagement with industry and used in previous analysis

[24] The £50 estimate comes from DWP Working Paper 107, "Processes and costs of transferring a pension scheme: Qualitative research with pension providers and third-party administrators", 2012.

schemes have already had time to familiarise themselves with the new legislation and plan for any changes required to their scheme rules. In addition, many new schemes will have already designed their rules to not allow short service refunds in advance of the new legislation coming into force.

Costs to scheme versus employers

40. The admin costs and benefits explained above will either fall to employers or scheme members depending on how each occupational money purchase scheme is governed and funded. In some cases, employers may choose to subsidise the administration and running costs of the occupational scheme made available to their employees. In these cases, the costs and benefits that have been attributed to schemes will also have an impact on employers. In other cases, employers may not provide any ongoing funding to the scheme, above the minimum employer contributions.

41. Following engagement with the Pensions Regulator, it is our understanding that typically administration costs incurred would be more likely to be met by the employer in an unbundled[25] occupational money purchase scheme and by the scheme (i.e. scheme members) in bundled[26] occupational money purchase schemes. The split of occupational money purchase schemes is 54% unbundled and 46% bundled[27]. Therefore, for the purposes of establishing the direct costs on business we assume the costs fall on the employer and scheme members equally[28]. This means we count the entire cost of the employer of no longer receiving a refund, but only half of the administrative costs of maintaining the dormant pot and half of the benefits from charges received and savings from no longer having to process refunds.

Overall Net Present Value (NPV) of abolishing SSRs

42. Based on the methodology stated above, and applying a 3.5% discount rate as advised in the Green Book, we estimate that the net present value is £33.75 million (net benefit) in 2014/15 prices, over a ten year period beginning in 2015/16. This shows that the benefits of increased pension rights for individuals far outweigh the short-term costs from no longer receiving refunds and the administrative costs involved in maintaining the pot.

Direct cost to business of the preferred option

43. Based on our estimates, the business net present value is -£119.80 million (net cost) in 2014/15 prices, over a ten year period beginning in 2015/16. The equivalent net cost to business of the Government’s preferred option, over the period of 10 years is estimated at around £10.59 million.

[25] In an unbundled DC trust based scheme the administration and investments are managed separately by selected third party providers.

[26] In a bundled DC trust based scheme a single third party provider provides both the administration and investment services.

[27] The Pensions Regulator (TPR), *DC trust: a presentation of scheme return data 2013-14*

[28] This approach is consistent with that used in the Minimum Governance Standards for DC trust-based schemes Impact Assessment, 2014.

Risks and assumptions

44. The costs and benefits presented are an assessment of the most likely impacts based on the evidence available. The costing is based on a number of assumptions around the future volumes of SSRs, the amounts refunded, and administrative costs associated with maintaining a pension and processing a refund. An underlying assumption is that there are no structural changes to the labour market such that employees change jobs more or less quickly compared to now. To test the sensitivity of the assumptions, high and low cost scenarios have been assessed.

High Cost Scenario

45. For the high cost scenario the volumes of SSRs in the future are increased by 25%, compared to the best estimate. This is broadly representative of a scenario where a far larger number of people automatically enrolled are in money purchase occupational schemes rather than workplace schemes, or where changes to the labour market mean employees move jobs more frequently than now.

46. For this scenario we also assume that the average contribution rates, particularly from employers, are higher by setting them at current levels, rather than halfway between the current levels and the automatic enrolment minimum levels. This may be representative of a scenario where employees and employers respond to messages about the need to save more, which cancels out any falls in average contributions due to new savers contributing the minimum under Automatic Enrolment. This means the refund that would have otherwise been received will be higher than for the best estimate. Finally we assume the real fund growth is 3% rather than 5% which means the employee's pension rights do not accrue as quickly.

47. These assumptions increase the costs but still generate a positive net present value of around £22m which suggests a net benefit to the policy even with these assumptions, partly because both the costs and benefits increase under this scenario. Under this scenario the equivalent net cost to business is estimated at £18m.

Low Cost Scenario

48. For the low cost scenario the volumes in SSRs in the future are reduced by 25% (compared to the best estimate), which maintains them at level comparable to the volumes seen prior to automatic enrolment. This may be realistic if, for example, a large number of new schemes set up for automatic enrolment decide to not allow SSRs as a result of the Government's announcements that they are to be abolished. For this scenario we assume contribution rates are equivalent to the minimum under automatic enrolment (4% for employee, 3% employer and 1% state). This reduces the amounts refunded. Finally we assume the real fund growth is 7% rather than 5% so pension rights accrue more quickly.

49. With these assumptions both the costs and benefits reduce, but the benefits to a lesser extent, such that the estimated Net Present Value increases to £36m. The estimate of the equivalent net cost to business reduces to £5.5m.

Small and Micro Business Assessment

Impact on small and micro employers

50. Around 40%[29] of employees work for small and microemployers. Employers of all sizes have a choice about whether to establish their own money purchase occupational scheme, or use a personal pension scheme or mastertrust for their employees. We expect the majority of small and micro employers who do not currently have a scheme to use a mastertrust or personal pension scheme for automatic enrolment, rather than establishing their own money purchase occupational scheme. DWP research states that around 65% of small and medium employers (with less than 250 workers) are expected to use National Employment Savings Trust (NEST)[30] to automatically enrol at least some of their workers[31].The Pensions Regulator has published guidance saying that most employers would find that it is not cost effective to set up their own occupational money purchase scheme unless it has at least 1,000 people saving in it.

51. The legislation applies to all employers / schemes regardless of size. However, evidence from DWP qualitative research[32] suggests that it is only the large employers and those with very high staff turnover that processed the large volumes of SSRs with the refunds being large enough to be of importance to the employer. The research states that, "The smaller employers and those with a low staff turnover considered the vesting rules to be of little overall importance, relative to other elements of a trust-based DC pension scheme. Indeed, many had never considered them to be a benefit at all, some pointing out that the administration involved in processing occasional short service refunds was in fact a disadvantage. "

    'They don't really offer much of a benefit. There is administration involved. It is not enormous but it is a bit of a nuisance really. I don't really see any benefit at all.'

    (Employer, 100 to 999 members)"

52. Therefore, we expect abolishing SSRs will predominantly affect the largest employers, especially those with high turnover, and for the vast majority of small and micro employers and schemes the impact will be negligible or nil.

Monitoring and Implementation Plan

53. The Commencement Order will made in the first quarter of 2015 and SSRs for money purchase occupational schemes will be abolished for new members from October 2015.

54. The change will be monitored by checking the volumes of money purchase occupational SSRs over time using the Occupational Pension Schemes Survey and HMRC tax data.

[29] Business Population Estimates 2013, Department of Business Innovation and Skills

[30] NEST is a qualifying pension scheme open to all UK employer's; established by law to support the introduction of automatic enrolment.

[31] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/209864/ad-hoc-supporting-ae-further-analysis.pdf

[32] "The use of vesting rules and default options in occupational pension schemes", DWP Research Report 725

Annex: Table of costs and benefits

The tables below show a breakdown of the estimated costs and benefits in each year. All figures are shown for calendar years in 2014 constant prices.

Costs (£m)	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Average Annual Cost
Employer no longer receiving refund	0.2	4.8	14.3	17.5	17.7	17.8	17.7	17.6	17.6	17.3	**14.3**
Employee no longer receiving refund	0.1	3.6	10.9	13.3	13.5	13.6	13.5	13.4	13.4	13.1	**10.9**
State no longer receiving tax paid on refund	0.0	0.8	2.5	3.1	3.1	3.2	3.1	3.1	3.1	3.1	**2.5**
Admin cost of maintaining dormant pot	0.0	0.2	0.7	1.4	2.1	2.8	3.5	4.1	4.8	5.5	**2.5**

Benefits (£m)	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Average Annual Cost
Employee pension rights	0.3	9.2	28.2	35.5	37.4	39.2	40.7	42.2	44.0	45.1	**32.2**
Admin savings from no longer processing refund	0.0	0.4	1.1	1.3	1.4	1.4	1.4	1.4	1.4	1.3	**1.1**
Charges received in respect of dormant pots	0.0	0.1	0.3	0.6	0.9	1.2	1.5	1.8	2.2	2.5	**1.1**