

Introducing a cap on early exit charges in trust-based occupational pension schemes

Department for Work and Pensions

RPC rating: fit for purpose

Description of proposal

In April 2015, the Government introduced pension freedoms enabling individuals aged 55 years and over who are members of a defined contribution pension scheme to access their pension fund early. However, early exit charges attached to some pension contracts have effectively prevented eligible individuals from taking advantage of this enhanced flexibility.

The Government, therefore, propose to legislate to place a duty on the Financial Conduct Authority (FCA) to cap early exit charges on contract-based pension schemes (regulated by the FCA) and on trust-based pension schemes (regulated by the Pensions Regulator – tPR). DWP and tPR will work in partnership with the FCA to develop the design and level of the cap, aligning this between both contract-based and trust-based pension schemes. The IA analyses the impact of a range of possible caps: 2%, 3%, 5%, 7% and 10% of the value of an individual's pension pot. At this stage, the Government do not have a preferred option.

Impacts of proposal

To estimate the impacts of the proposal, DWP has used data from tPR on the number and types of firms in the trust-based market, and data from the FCA on the range of charges currently applied to early exits from contract-based schemes.

The main cost to business is the cost of foregone early exit charges. Assuming schemes do not attempt to recoup this revenue by other means, the total benefit to members will equal this cost to business. DWP assumes that one in five members will take up the pension freedoms as a result of the proposal. This assumption is consistent with that used by HM Treasury in its recent IA (RPC-3257(1)-HMT) on a cap for early exit charges on contract-based pension schemes. DWP estimates this cost to business, and benefit to members, would range between £1.5 million (with a 10% cap) and £3.88 million (with a 2% cap) in the first year, and £0.19 million and £0.51 million respectively in all subsequent years. DWP estimates this cost profile as FCA data suggests there is significant “pent-up” demand in the market.

Businesses will also incur administrative costs from operating the cap, and familiarisation costs. DWP assumes that businesses will continue to use their existing systems to operate the cap. Administrative and familiarisation costs are estimated to total between £0.35 million (with a 10% cap) and £0.59 million (with a 2% cap) in the first year, followed by administrative costs of £0.01 million and £0.04 million respectively in all subsequent years.

The IA explains that businesses may recoup the costs of the charges foregone, for example via a joining fee or through the annual management charge (AMC). This indirect effect has not been monetised.

The proposal is a qualifying regulatory provision that should be accounted for under the business impact target. At this stage, depending on the level of the cap chosen, DWP estimates an equivalent annual net direct cost to business (EANDCB) of between £0.4 million (with a 10% cap) and £0.9 million (with a 2% cap).

Quality of submission

DWP uses FCA data on the exit charges currently applied in the contract-based market to estimate the cost to business and benefit to members. The IA explains that there are limited data on current exit charges in trust-based schemes, and that several large pension providers operating in both the contract and trust side of the market have reported to the FCA that their charging structures for the two markets are aligned or very similar. DWP, therefore, concludes that it is reasonable to apply the same range of charge levels to both types of scheme. DWP must seek evidence from a wide variety of trust-based pension providers, including small and micro businesses, on the extent to which this is an appropriate proxy.

DWP assumes that businesses will not recoup the costs of the charges foregone for several reasons, including that “*Market forces should dictate that if the provider increases the AMC, the trustees will move to another provider at the next opportunity to protect their members’ interests*” (page 21). DWP must seek evidence during consultation on the extent to which these indirect lower costs to business, or reduced benefits to members, are likely to be realised.

DWP assumes that businesses would continue to use their existing systems and implement the cap by manually overriding them. DWP should also seek evidence on the extent to which businesses feel it would be necessary to implement up-front system changes to meet the requirements of the proposals at lower cost. In the final stage IA, DWP must provide a discussion of this evidence and refine, as necessary, its estimate of the administrative cost of the proposal.

DWP assumes that the number of individuals affected will be 1,100 in each year from 2018 onwards. This assumes that the population aged over 55 years is static over time. The final stage IA should amend this assumption to reflect projected changes in this population size, or justify why this cannot be done.

The final stage IA should also consider the following:

- The risk to pension saving in the long run as a result of the proposal.
- Any lost earnings to business as a result of having fewer funds under management.
- The extent to which individuals will seek to withdraw a larger proportion of their pensions than they would have under existing charges, as well as the extent to which some individuals would seek to access their pension pots early as a result of the proposal.

Small and micro business assessment (SaMBA)

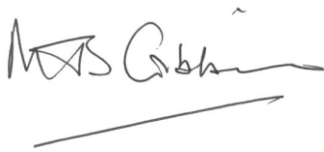
The SaMBA explains that the pension providers and administrators affected are typically large businesses servicing a number of schemes, including micro schemes, although there will be a minority of smaller businesses also. However, DWP explains that, even for self-administered small and micro businesses, the work required to cap the relevant charges is not likely to be a separate, one-off task but instead will be part of their usual business. DWP also explains that if evidence emerges during consultation that the cap would have a disproportionate impact on small and micro businesses, the Government would expect to take steps to mitigate these impacts. This evidence must be discussed at the final stage.

Departmental assessment

Classification	Qualifying regulatory provision (IN)
Equivalent annual net cost to business (EANCB)	Between £0.4 and £0.9 million, depending on the level of the cap chosen
Business net present value	Between -£3.4 million and -£8.6, depending on the level of the cap chosen
Societal net present value	Between -£0.89 and -£0.41 million, depending on the level of the cap chosen

RPC assessment

Classification	Qualifying regulatory provision (IN)
Small and micro business assessment	Sufficient at this stage



Michael Gibbons CBE, Chairman