Title: Power to amend schemes to reflect abolition of contracting-out: statutory override regulations **Lead department or agency:** DWP **Other departments or agencies:**	**Impact Assessment (IA)** **Date: 08 May 2014** **Stage:** Consultation **Source of intervention:** Domestic **Type of measure: Secondary Legislation** **Contact for enquiries:**

Summary: Intervention and Options

RPC Opinion: Not in scope

What is the problem under consideration? Why is government intervention necessary? The new State Pension will be a simple, flat-rate contributory pension. Reforming the system into a single payment will close the additional State Pension (AP). This, in turn, will end the system which enables sponsors of defined benefit (DB) schemes (also known as salary related occupational pension scheme or final salary) to contract members out of the AP. The abolition of contracting-out will result in additional National Insurance (NI) costs for relevant employers. The Government proposes to give private sector employers limited powers to change pension scheme rules without trustees' consent to recoup the additional cost in NI contributions resulting from the abolition of DB contracting-out. This is known as the "statutory override". When the new State Pension begins in April 2016, employers will be able to use the power in the Pensions Bill 2013-14 to amend their schemes, but there is no compulsion on employers to use it. Any scheme changes must be certified by an actuary as recovering no more than the increase in NI costs. The Government is consulting on draft secondary legislation now, so it can bring measures into force in time to give employers and pension schemes sufficient notice to implement the changes and to ensure a smooth end to contracting-out. The introduction of the statutory override will provide the vast majority of private sector employers with a range of options to mitigate the impact of the ending of contracting-out.

What are the policy objectives and the intended effects? The policy objective for the statutory override is to ensure that the sustainability of DB schemes is not undermined by minimising the impact of the loss of the NI rebate on employers and schemes. Employers will be able to amend scheme rules without trustee approval, reducing scheme costs to reflect the increase in employer NI costs when contracting-out ends

What policy options have been considered, including any alternatives to regulation? (further details in Evidence Base)
Two options were considered 1) do nothing (i.e. end contracting-out for DB schemes with no mitigating statutory override) and 2) provide a statutory override for employers from 2016 which would give employers three options to mitigate the loss of the NI rebate passing by:

- raising members' pension contribution rates;
- changing the scheme benefit structures from 2016 (the point when contracting-out is abolished);
- or a combination of the above.

Do nothing is not a realistic option given the aim of not undermining the sustainability of DB schemes. Employers have asked for an option to mitigate the impact of the loss of the NI rebate. In the absence of a statutory override some employers would have to agree changes to scheme rules with pension scheme trustees or absorb the costs associated with paying higher pension benefits following the loss of the NI rebate. Without the statutory override some employers may be more likely to close their scheme.

Option 2 ensures that the vast majority of private sector employers have an option available to them to mitigate the loss of the NI rebate. A non-regulatory alternative has not been considered because there is a legal framework for pensions which has to be altered to deliver the mitigating options. The mitigating options could not be achieved through non legislative means (e.g. industry agreement, guidance etc) because some private sector employers are limited in their ability to modify the scheme benefits structure by legislation or by the scheme rules themselves. In many cases, scheme rules can only be changed by trustees or with trustees' consent. As changes in response to the end of contracting-out are likely to reduce members' pension income or increase their contributions, it is possible that trustees may not consent to them.

Will the policy be reviewed? It will not be reviewed. The override will only be available for 5 years unless extended.

If applicable, set review date: Month/Year

Does implementation go beyond minimum EU requirements?			N/A		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** Yes	**< 20** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** 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: Steve Webb Date: 08/02/2014

Background

The State pension system currently

1. There are two parts to the current state Pension system. The basic state Pension is a flat rate pension and full entitlement is gained by building up 30 qualifying years of National Insurance Contributions (NICs) or credits. There is also an earnings-related component of state pension provision known as the additional state pension (AP) – the main component of AP is the State Second Pension (S2P) (formerly State Earnings Related Pension Scheme (SERPS) before 2002).

Abolition of contracting-out through DB pensions

2. Currently employers sponsoring defined benefit (DB schemes) can contract-out of AP which means scheme members give up entitlement to the AP in return for a lower NI rate for employers and employees providing the pension scheme sponsored by the employer meets the minimum requirements for contracted-out DB schemes (the Reference Scheme Test). With the introduction of a new State Pension the AP will close. As a consequence, contracting-out of the AP will come to an end for DB pension schemes.

3. Employees who are contracted-out when the new State Pension is introduced will be automatically brought back into the full state scheme. Both employer and employee will stop paying a lower rate of NI and instead pay the full rate of NI. The impact of the abolition of contracting-out on employee and employer NICs is considered in chapter 5 of the single-tier Impact Assessment:

   https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/254151/a-pensions-bill-single-tier-ia-oct-2013.pdf

4. The consultation document which accompanies this impact assessment provides full details of the proposed legislative changes which follow from the abolition of DB contracting-out. These draft provisions provide detail on the operation of the statutory override, replace the Occupational Pension Schemes (Contracting-out) Regulations 1996 and make miscellaneous minor and technical changes to secondary legislation to reflect the abolition of contracting-out.

The provision of a statutory override

5. Many organisations who responded to the Government's consultation on state pension reform, '*A State Pension for the 21st Century*' (the Green Paper), told us about the significant implications that ending contracting-out for DB schemes would have for sponsoring employers, schemes and employees. The Pensions Bill 2013-14 contains provisions to grant sponsoring employers in the private sector a statutory override allowing them to alter the terms of their DB schemes without trustee consent to recoup the cost of the additional NICs which will result from the end of contracting-out.

6. This impact assessment focuses on the costs and benefits associated with the provision of this statutory override for employers. Other changes to secondary legislation to reflect the ending of contracting-out are of a minor and technical nature.

Rationale for intervention

7. The rationale for intervention is to ensure that the sustainability of DB schemes is not undermined by easing the burdens on employers who will no longer receive the NI rebate.

Policy Objective

8. The policy objective for the statutory override is to ensure that the sustainability of DB schemes is not undermined by minimising the impact of the loss of the NI rebate on employers and schemes. Employers will be able to amend scheme rules without trustee approval, reducing scheme costs to reflect the increase in employer National Insurance costs when contracting-out ends.

Description of options considered

9. The Government has considered two options:

Option 1: Do nothing (i.e. end contracting-out for DB schemes with no mitigating statutory override)

10. In this instance the do nothing option relates to doing the minimum needed to achieve the ending of contracting-out without the provision of the statutory override. This would limit the options available to employers to mitigate the increase in employer NICs.

11. Do nothing is not a realistic option given the aim of not undermining the sustainability of DB schemes and minimising the impact of the ending of contracting-out on employers. Employers have asked for an option to mitigate the impact of the loss of the NI rebate. In the absence of a statutory override employers may have to agree changes to scheme rules with pension scheme trustees or absorb the costs associated with paying higher pension benefits following the loss of the NI rebate. Without the statutory override some employers who feel they may not be in a position to gain agreement to make appropriate changes to the scheme may be more likely to close their scheme.

Option 2: Provide a statutory override for sponsoring employers from 2016 to mitigate the loss of the NI rebate

12. Introducing a statutory override ensures that the vast majority of employers have a range of options available to them to mitigate the loss of the NI rebate.

13. The Pensions Bill 2013-14 includes legislation to allow private sector employers limited powers to change scheme rules for this purpose without trustee consent. The statutory override enables employers to make an adjustment to future pension benefits or contribution rates to offset the end of the NI rebate. The new powers will allow for the statutory override to be used more than once so employers can phase in changes if they choose. However, any scheme changes must be certified by an actuary as 'recouping no more than' the employers increase in NI cost before proposed changes under the statutory override can be implemented. The statutory override would be available for 5 years unless extended.

14. Scheme members do have to be consulted about potential changes by the employer in relation to the statutory override. The obligation to consult is an existing statutory requirement. The Government proposes to enable employers to change scheme rules without trustee content; however, it does not propose to also remove the requirement to consult on scheme redesign with their employees.

Preferred option

15. The Government's preferred option is option 2, to introduce a statutory override for private sector sponsoring employers as drafted in the Pensions Bill 2013-14.

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

16. The impact of the abolition of contracting-out on employee and employer NICs is considered in chapter 5 of the single-tier Impact Assessment:

    https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/254151/a-pensions-bill-single-tier-ia-oct-2013.pdf

17. This impact assessment focuses on the costs and benefits associated with the provision of the statutory override to employers.

Individuals and schemes in scope of the statutory override

18. According to the Occupational Pension Schemes Survey (OPSS) Annual Report 2011, (ONS)[1], there are currently 1.6 million active members[2] of contracted-out DB schemes in the private sector and 5.3 million active members of contracted-out DB schemes in the public sector (see Table 1).

19. In the private sector there has been a decline in the number of active members of contracted-out DB schemes from 3 million in 2004 to 1.6 million in 2011, this reflects the wider decline in DB schemes in the private sector[3]. Over the same time period there has been an increase in the number of active members of contracted-out DB members in the public sector from 5 million in 2004 to 5.3 million in 2011. Numbers of active members of contracted-out DB schemes are expected to decline in both the public and private sectors up to 2016, reflecting the long-term decline in DB membership in the private sector and the contraction in the number of public sector employees.

Table 1: Number of active members of contracted-out DB schemes, by size of membership and whether in public or private sector, 2011

	Membership of DB schemes (millions)	
Membership size	**Private Sector**	**Public Sector**
5000+	1.2	5.3
1,000-4,999	0.2	0.1
100-999	0.1	0
12-99	0	0
2-11	0	0
Total	1.6	5.3

Source: OPSS data 2011
Note: Totals may not sum due to rounding

20. Although the number of individuals potentially affected by the ending of contracting-out will be largest in the public sector, Table 2 shows that the number of individual schemes affected

[1] http://www.ons.gov.uk/ons/rel/pensions/occupational-pension-scheme-survey-annual-report/2011-annual-report/index.html
[2] Active members are those that continue to accrue new pension rights in a scheme.
[3] See for example '*Pensions: Challenges and Choices, -The First Report of the Pensions Commission*', 2004.

will be greater in the private sector. In 2011 there were 3,290 contracted-out DB schemes in the private sector compared with 331 in the public sector.

Table 2: Number of contracted-out DB schemes, by size of membership and whether in public or private sector, 2011

	Number of DB schemes	
Membership size	**Private Sector**	**Public Sector**
5000+	140	132
1,000-4,999	450	69
100-999	1,600	63
12-99	--	37
2-11	--	30
Total	3,290	331

Source: OPSS data 2011
Note: Totals may not sum due to rounding

21. In April 2016, when the new State Pension is implemented and contracting-out ends, all employees who were members of a contracted-out scheme immediately before implementation will cease to receive the 'NI rebate' and will start to pay full NICs, bringing them into line with the rate of NI that is paid by other employees.

22. It is expected this will affect around 950,000 people in the private sector and 4.5 million in the public sector, as the number of active members in DB schemes is expected to reduce.

Costs to private sector employers (option 2)

23. DWP sought the views of sponsoring employers in the private sector affected by the ending of DB contracting-out. Many respondents to the consultation indicated that employers thought it unreasonable that they had to bear the cost of paying higher NICs whilst maintaining the same scheme benefits. They therefore wished to reduce the level to which they must fund their scheme by the same amount as the increase in NICs, reflecting the fact that employees would be brought back fully into the state pension system when contracting-out ends. This could be done by reducing future pension benefits or increasing employee contribution rates to their pension schemes.

24. The Government intends to give private sector employers limited powers to change scheme rules for this purpose without trustee consent. The statutory override enables employers to make an adjustment to future pension benefits or contribution rates to offset the end of the NI rebate (option 2). The new powers will allow for the statutory override to be used more than once allowing employers to phase changes. However, any scheme changes must be certified by an actuary as 'recouping no more than' the employers increase in NI cost before they can be implemented.

25. The proposed statutory override regulations do not impose any direct cost on employers. It gives them the flexibility to change scheme rules without trustee consent to compensate for the loss of the NI rebate. The use of the statutory override is at the discretion of the employer. It is important to note that if employers choose to attempt to change their scheme rules then there will be professional and administrative costs associated with making that

change, regardless of whether they use the statutory override to effect that change. There are no legal barriers to changing scheme rules, but the statutory override will make it easier for employers to make changes without trustee consent.

26. We do not know with any certainty the proportion of private sector employers sponsoring a contracted-out DB scheme that will use the statutory override, as noted in the White Paper – *The single-tier pension: a simple foundation for saving*, many private sector employers have indicated a strong appetite for a mechanism to mitigate the impact of the ending of contracting-out. For the purposes of the calculations presented here we have assumed that all schemes would use the statutory override. This is in line with the assumption made in the single-tier Impact Assessment that employers would pass on the costs of the lost rebate to their employees immediately and in full by increasing employee contribution rates to their pension schemes, reducing future pension scheme benefits or a combination of both.

27. If employers choose to use the statutory override to change their scheme rules there will be professional fees (legal and actuarial costs), administration costs and communication costs. These costs represent costs to changing their scheme and are voluntary and not imposed directly as result of the regulations. Industry sources have advised that the costs associated with using the statutory override will vary depending on whether employers choose to change contribution rates or change future pension benefits. An increase in contribution rates will be less complex and therefore cheaper to implement, whereas a change to future benefits will be more complex to implement and will be more costly.

28. Industry experts have suggested that if the change is relatively straightforward and a simple consultation exercise is undertaken, a large scheme (1000 plus members) may spend around £100,000 changing their scheme rules using the statutory override, a medium sized scheme (100-999 members) may spend around £50,000 and a small scheme around £20,000 (fewer than 100 members). If all private sector contracted-out schemes used the statutory override the estimated cost of changing scheme rules would be around £161m in 2013/14 prices in 2016/17 (Table 3). These costs represent the costs associated with making voluntary changes to scheme rules to mitigate the impact of the NI increase and are not directly imposed as a result of the statutory override.

Table 3: Estimated transitional costs of using the statutory override (2013/14 prices)

Scheme size	**Number of Schemes**	**Estimated Cost per scheme £m**	**Estimated Cost £m**
5000+	140	0.1	14
1000 to 4999	450	0.1	45
100 to 999	1,600	0.05	80
Below 100	1,100	0.02	22
Total	3,290	-	161

Source: DWP calculations and the Occupational Pensions Scheme Survey 2011

29. These estimates assume that the statutory override is used only once and employers make the correct changes first time. We have no information on how many times an employer would use the powers, but the expectation is that employers will seek to minimise cost by making the correct changes first time.

30. Although there is a cost to employers of using the statutory override, re-designing the scheme is a voluntary decision made by the employer to mitigate the ending of the NI rebate. Any costs incurred by the sponsoring employer in using the statutory override would be in the expectation that these would be outweighed by the longer-term benefits of making these changes. As a consequence, we estimate that the benefits to employers if they all use the statutory override, will be **greater than the £161m** estimated cost of implementing the

changes required to scheme rules. The exact level of benefits will depend on what changes to the scheme employers make: they are limited to the maximum changes they make; but some may choose to make changes which do not fully cover their additional NI costs.

31. If not all schemes use the statutory override then the costs and benefits would be lower but as the statutory override is voluntary we would still expect the benefits to outweigh the costs. For example, some employers may not use the statutory override if there are positive but relatively modest (and uncertain) net returns from using it.

Protected Persons

32. There is a small group of individuals (approximately 60,000) employed in some formerly nationalised industries (rail (including Transport for London), electricity, coal, nuclear waste and decommissioning), where the employers and trustees are limited in their ability to change scheme rules by legislation made during privatisation. This legislation prevents employers from making changes to the pension benefits offered to those employees who were previously employed by the State.

33. The consultation document which accompanies this impact assessment specifies details in regulations[4] that employers should not be allowed to use the statutory override to alter the pension schemes in relation to members with protected person status. We do not have reliable information to robustly quantify this impact therefore no allowance has been taken for protected persons in the calculations presented here.

34. Further details on protected persons can be found in the Government's response to the protected persons consultation and in the supporting impact assessment:

    https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/278979/government-response-protected-persons-consultation.pdf

    https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/278982/impact-assessment-protected-persons.pdf

Impact on the Exchequer

35. There will be a small administrative saving to Government from no longer having to administer DB contracting-out schemes. Estimates of these savings are not available from HMRC so are non monetised in this impact assessment. We will provide further information on these savings, if information becomes available, in the final stage impact assessment.

Risks and Assumptions

36. The main assumptions used in the estimates are:

- all employers sponsoring contracted-out DB schemes are assumed to use the statutory override; this implies that the full cost of the loss of the rebate is passed on immediately to employees in the private sector;
- the costs associated with using the statutory override to change scheme rules without trustee consent are assumed to be £100,000 for schemes with greater than 1000 members, £50,000 for schemes with 999-100 members and £20,000 for schemes with fewer than 100 members, based on information provided confidentially by industry;
- the costs associated with using the statutory override occur in 2016/17;
- all values that are shown in 2013/14 prices have been deflated using the GDP deflator.

[4] The draft Occupational Pension Schemes (Power to Amend Schemes to Reflect Abolition of Contracting-out) Regulations 2014

37. There is uncertainty around the estimates of the one-off cost of using the statutory override. This is because we do not know with any certainty what proportion of employers sponsoring contracted-out DB schemes will in fact use the statutory override. In addition there are also uncertainties around the costs associated with using the statutory override which will be influenced by whether employers increase contributions or change future benefits and the nature of the consultation exercise. The estimate of the costs associated with using the statutory override is based on Occupational Pension Scheme Survey data about the number of contracted-out private sector DB schemes and the size of these schemes. Data on scheme numbers is weaker than other OPSS estimates as the survey is designed primarily to measure membership numbers. We also assume that the statutory override is used only once and employers make the correct changes first time, we have no information on how many times an employer would use the powers, but the expectation is that employers will seek to minimise cost by using the statutory override once.

38. The estimate of the costs of using the statutory override to change scheme rules without trustee consent should be interpreted with caution given the uncertainties outlined above. Nevertheless, as use of the statutory override is voluntary, employers choosing to use the statutory override to change their scheme rules without trustee consent are likely to do so in the expectation that the longer-term benefits will outweigh the short-run costs associated with changing scheme rules.

Small and micro businesses

39. The majority of sponsoring employers of contracted-out DB schemes are large and medium sized employers. However, the Department recognises that some small and micro businesses will be affected by the ending of DB contracting-out. The availability of the statutory override will ensure that the vast majority of private sector employers, of any size, have a range of options to mitigate the impact of the loss of the NI rebate.

Summary and implementation plan

40. The Department is making minor and technical changes to secondary legislation which is essential in order to fully implement primary legislative changes in the Pensions Bill 2013-14 following the abolition of DB contracting-out.

41. The consultation document, which accompanies this impact assessment, asks for views on proposed legislative changes which follow from the abolition of DB contracting-out. We are also seeking to obtain more information on the costs to businesses planning to use the statutory override to change their scheme rules, such as professional fees (legal and actuarial costs), administration and communication costs. We would be grateful if respondents could include estimates of costs, by scheme size, including a breakdown of fees, where possible.

42. The draft Occupational Pension Scheme (Power to Amend Schemes to Reflect Abolition of Contracting-out) Regulations 2014 will come into force later this year to allow employers to plan changes and to consult employees in good time to implement in April 2016.