Opinion: Enactment IA validation
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Implementation of a cap on early exit charges on pension schemes

HM Treasury

RPC rating: validated

The impact assessment (IA) is now fit for purpose as a result of the Department's response to the RPC's initial review. As first submitted, the IA was not fit for purpose.

Description of proposal

In April 2015, the Government introduced the 'freedom and choice pension reforms' to allow everyone aged 55 or over with a defined contribution pension to access their pension savings flexibly by 'exiting' from the scheme before the selected retirement date. However, early exit charges attached to some pension contracts have effectively prohibited eligible individuals from taking advantage of this enhanced flexibility. HM Treasury amended the Financial Services and Markets Act 2000 to give the Financial Conduct Authority (FCA) a duty to make rules requiring relevant firms to cap the early exit charges imposed on contract-based pension policies.

The FCA has made its rules and provided HM Treasury with details of the resulting impacts on business. In line with a previous agreement with the RPC, HM Treasury is now able, via an enactment stage IA, to provide a robust estimate of the cost to business for validation by the RPC.

Impacts of proposal

HM Treasury explains that following evidence gathering and cost-benefit analysis the FCA has determined that early exit charges:

- Will be capped at 1% of the value of a member's benefits being taken, converted or transferred from a scheme;
- Cannot be increased in existing schemes that currently have early exit charges set at less than 1% of the member's benefits under a scheme.
- Cannot apply in schemes entered into after the proposed new rules come into force.

Costs

The main monetised cost to businesses that administer schemes is the loss of the early exit charges that would no longer be paid due to the cap and the cost of administering the policy. The FCA estimates a cost to business of £45.5m, over four years, for the loss of early exit charges and £17.4m, in the first year of the policy, for compliance costs.

In calculating the loss to pension providers, arising from early exit by customers when a cap is applied, the FCA assumed that, in the absence of capping, firms would have set their early exit charges to equal the amount of revenue that they would have earned on the policy had the policyholder stayed in the scheme until the expected retirement date. The FCA has treated the difference between the uncapped and capped charge as an estimate of the loss of income to business per customers

The department also provides an estimate for the number of additional customers that exit early/earlier when a cap is applied. Combining this with the FCA's assumption about loss of income, gives an estimate of £19.1m over four years for the loss to business. This is treated as an indirect impact because it arises from customers responding to the cap.

Finally, the IA also discusses the solvency impact of the measure upon pension providers to ascertain their ability to absorb the likely revenue loss while remaining solvent. The FCA, from its discussions with firms, does not expect the impact of the cap to materially affect the financial status of firms or compromise their solvency.

Benefits

The IA explains that individuals seeking to access the new freedoms will receive benefits equal to the cost of the foregone exit charges. The IA therefore states that there are 312,000 pension pots that would be subject to exit charges of greater than 1%. These pots would accrue combined exit charges of £405m. If each pot was capped at 1%, then the total amount saved per pot would be on average £1140.69. By multiplying the average saving per pot by the number of exits the FCA expects benefit to consumers from the policy equal to £45.5m, or £10.66m per year.

The department uses a four year appraisal period and calculates the EANDCB over this period. This is on the basis that the FCA's cost benefit analysis considered that potential losses beyond 2020 will be increasingly insignificant. This was because "*the number of existing personal and stakeholder pension schemes with early exit charges in excess of 1% is small (in June 2015, 84% of policies held by consumers eligible to access the freedoms would not attract exit charges). Since the contracts on which exit charges are levied were generally written in the 1980s and 1990s, it is likely that many of these policies will reach their selected retirement age by 2020*" (page 4).

The RPC verifies the estimated equivalent annual net direct cost to business (EANDCB) of £14.3m. This is a qualifying regulatory provision that will score under the Business Impact Target.

Quality of submission

The department has revised the enactment IA in response to issues raised by the RPC's initial review, providing responses on the following points:

- The department has provided a clearer rationale for its decision to appraise the measure over four years. It presents the FCA's reasoning for this, namely that: "*The number of existing personal and stakeholder pension schemes with early exit charges in excess of 1% is small. Since the contracts on which exit charges are levied were generally written in the 1980s and 1990s, it is likely that will reach their selected retirement age by 2020"* (paragraph 16). This assumption has been supported by evidence gathered from businesses;
- The assessment now provides, as requested by the RPC, separate figures for the direct impact of lower charges for those who would be exiting anyway (£45.5m) and the impact of additional customers exiting due to the cap (£19.1m), which the department classifies as indirect, based on the FCA's analysis (paragraph 30).
- The IA now addresses the behavioural issues – in particular around take-up rates and the possibility that individuals will make less appropriate pension provision or riskier decisions – that were noted in the RPC's previous Opinion, dated 31 March 2016. It also provides better evidential support for the assumptions, in particular around the time taken to process the transfer of a pension, the level of the cap, and the loss of earnings to business as a result of having fewer funds under management.

The department classifies the additional exits resulting from the cap as an indirect impact and uses a four, rather than ten, year appraisal period. The additional exits involve an additional step, in terms of customers changing their behaviour as a result of the cap. Set against this, the impact clearly occurs in the same market. Re-classifying this impact as direct would increase the EANDCB to about £18.6m. The four year appraisal period would be appropriate if the policy was not 'active' beyond this point. This could be the case if virtually all customers on pension contracts where exit charges are levied will have reached their selected retirement age by 2020. This appears to be the department/FCA's position, although it is not absolutely clear from the IA that there will be no significant impacts after 2020. Overall, the department has provided just sufficient information to support its approach and to allow the RPC to validate the EANDCB in this particular case. The IA would, however, have benefited, in particular, from providing further reassurance that impacts after four years are insignificant.

Other comments

Overall NPV

The department provides an overall NPV figure of -£78.8m. This appears to be approximately the business NPV figure (-£60.6m) used for calculation of the EANDCB plus the £19.1m indirect cost referred to above. Although the IA does include an assessment of the benefit to customers from lower charges, this benefit is incorrectly omitted from the overall NPV and is not adequately included in the summary sheets of the IA. The department's assessment of the overall impact of the measure is, therefore, not fit for purpose.

The department has previously stated that the majority of small and micro businesses within the FCA-regulated pensions industry were small Self-Invested Personal Pension (SIPP) providers and were likely to have cost models and systems in place that will result in a relatively low cost of implementing the cap. The IA states that data was gathered from a representative sample of SIPPs. However, the IA would have benefited from providing more detail to support this statement on the impact on small and micro businesses, as requested in the RPC's previous opinion dated 31st March 2016.

Departmental assessment

Classification	Qualifying regulatory provision (IN)
Equivalent annual net cost to business (EANCB)	£14.3 m
Business net present value	-£60.6 m
Societal net present value	-£78.8 m

RPC assessment[1]

Classification	Qualifying regulatory provision (IN)

[1] The RPC verification of the estimated equivalent annual net cost to business (EANCB) and assessment of whether the measure is a qualifying regulatory provision are based on current working assumptions.

EANCB – RPC validated	£14.3 m
Business Impact Target (BIT) Score	£57.2 m

Michael Gibbons CBE, Chairman