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8 July 2014

Department for Work and Pensions
Contracting-out Policy Team
Level 1
Caxton House
Tothill Street
London SW1H 9NA

Dear Sir / Madam

Abolition of defined benefit contracting out

I am writing on behalf of the Association of Consulting Actuaries (ACA) in response to the consultation document dated 8 May 2014. I apologise for missing the 2 July 2014 deadline but hope that you can take our views into account.

We have chosen not to respond to the 26 questions being asked in relation to the draft Occupational Pension Schemes (Power to Amend Schemes to Reflect Abolition of Contracting-out) Regulations 2014. This is because firstly we have been involved in a number of discussions with DWP officials before the regulations were issued for public comment and as a result of this process a number of our thoughts and observations were taken on board. Our second reason is because policy has largely now been settled and so the issue is one of ensuring that the regulations adequately reflect this position. We have had sight of the proposed response by the Institute and Faculty of Actuaries to this public consultation and as we find ourselves largely in agreement with the points that they make see no reason to duplicate them in a separate response.

We have responded to the three questions being asked in relation to the draft Occupational Pension Schemes (Schemes that were Contracted-out) Regulations 2014. You will find our thoughts in the Appendix to this letter.

We hope that you find our comments of assistance and would be happy to discuss them further if that is helpful. Please contact either me on 020 7432 6635 (david.everett@lcp.uk.com) or my colleague, Jane Beverley on 020 3327 5314 (jane.beverley@puntersouthall.com) who prepared the response on the Schemes that were Contracted-out regulations.

Yours faithfully

David Everett
Chairman
ACA Pension Schemes Committee

Sent by e-mail to: contracting.outteam@dwp.gsi.gov.uk

APPENDIX

ACA'S RESPONSES TO SPECIFIC QUESTIONS

The draft Occupational Pension Schemes (Schemes that were Contracted-out) Regulations 2014

***Question 27**: Do you agree that the proposed changes will achieve the intended effect of preserving accrued contracted-out rights since 1978?*

Whilst this is a question that would be better answered by pension lawyers, we would broadly agree that the changes will have the effect of preserving contracted-out rights since 1978. We do, however, have some comments on the draft regulations as set out below:

<u>Regulation 2</u>

Whilst the definition of section 9(2B) rights is essentially the same as that in the existing 1996 Contracting Out Regulations, it is not clear why a definition incorporating 'protected rights' needs to be retained following their abolition in 2012.

<u>Regulation 5</u>

The drafting of 5(1) seems odd. Is there something missing after 'could'?

<u>Regulation 18</u>

Regulation 42(2ZA) of the 1996 Contracting Out Regulations requires the scheme to provide benefits 'which are at least equal to the benefits that would be provided <u>under a reference scheme</u>'. However, regulation 18 of the draft regulations specifies that the scheme should provide benefits 'which are at least equal to the benefits that would have been <u>provided to the earner's widow, widower or surviving civil partner before the alteration</u>'. This seems to introduce a higher test, since the scheme may well have been providing a higher level of benefits than would be provided under a reference scheme. It is not clear why these regulations (which should simply aim to replicate the existing legislation on contracted-out benefits) should seek to increase the protection of benefits in this way.

We also note that 18(2)(a) replaces *"either as regards the amount of the pension <u>or</u> as regards the circumstances in which it will be paid"* with *"both as regards the amount of the pension <u>and</u> as regards the circumstances in which it will be paid"*. We are not clear whether this represents a change of policy (on the face of it, 'both/and' would appear to be a higher test than 'either/or') or whether the DWP's view is that it is simply correcting an error in the original drafting (which would otherwise appear to allow the amount of pension to be reduced so long as the circumstances in which it is paid are unchanged).

The net effect of both these adjustments is that it would seem very unlikely to be possible to make any changes to section 9(2B) rights other than to increase them. So it would not be possible to substitute them with benefits whose actuarial value was at least as great, nor would it be possible to utilise member consent.

It is not clear whether you intend that Section 67 of the Pensions Act 1995 is effectively overridden in relation to these benefits. We also suggest that this treatment is inconsistent with that for GMPs where it is possible to convert them to other benefits whose actuarial value is at least as great as the GMP that they replace.

When Regulation 42(ZA) was being proposed through the Occupational and Stakeholder Pension Schemes (Miscellaneous Amendments) Regulations 2013 we questioned the need for such protections given the existence of Section 67 and trust law. We ask you once more to reconsider and especially as you appear to have strengthened them. These greater restrictions will act as a severe deterrent to employers who wish to simplify accrued benefits to aid member understanding.

Regulations 19 and 31

While the regulations are intended to replicate current requirements rather than change them, we would request serious consideration of one change, because of the material simplification it would bring to administering pension schemes. We would not like to miss this opportunity and find that an onerous obligation is embedded in longer term provisions.

Our request relates to the circumstances in which GMP or Section 9(2B) rights can be paid as retirement cash.

Under the current regulations it is possible to replace GMP or Section 9(2B) rights with a cash sum at retirement where paying a cash sum would be authorised under tax legislation specifically as one of the following:

- a trivial commutation lump sum or a winding up lump sum (and their equivalent death benefit lump sums);
- for small pot lump sums under 2009 regulations (for and in respect of the member); or
- (solely in the case of Section 9(2B) rights and not GMP) “pension commencement lump sum” which is, broadly, potentially 25% or more of a member’s total rights.

The combination of draft regulations 19 and 31 confirm continuation of current provisions, unchanged.

We ask you to revisit the possibility of adding on to this list where the lump sum would be authorised under tax legislation as a “lifetime allowance excess lump sum” (LTAXS).

As you know, broadly, pension tax law authorises a scheme to pay such a lump sum only once the member has already started to draw benefits from registered pension schemes worth a capitalised value of more than the Lifetime Allowance (£1.25m at the moment). The remaining tranche of benefits is subject to “super-tax” that claws back the tax advantage of having saved for that in a tax-registered pension scheme. Hence correspondingly the tax law takes away the imposition that that tranche has to be drawn as lifetime pension. Typically whether trustees of schemes actually offer this option to a member will depend on the scheme's own rules and may well be a matter of trustee discretion.

We would make the following observations (which we are sure other pension industry bodies would agree with):

- **The current block is not needed to protect the individuals concerned** – by definition individuals who are able to take an LTAXS under pension tax law have already substantial private pension provision.

- **The block is not needed to protect other members** – we understand that you have previously argued that allowing the payment of an LTAXS might disrupt the funding of a scheme because it gives a member access to full security for a tranche of benefit which would otherwise be a low priority layer of benefit were the scheme to wind up in deficit. However, why is it relevant that contracting-out is the key determining factor? Our understanding is that around 10% of defined benefit schemes have never been contracted-out and hence have always been able to make such payments. Trustees usually have sufficient powers and duties to manage the affairs of schemes and can choose not to allow LTAXS if in their view this would prejudice scheme funding.

Moreover, the current provisions and draft make clear that to the extent that an individual has pre 1997 excess over GMP or other non-contracted-out benefits, an LTAXS can be paid in respect of those balance benefits.

The new regulations are an opportunity for you to review this matter from first principles. It would be a welcome and significant easement of DWP practice if all schemes were permitted to pay LTAXS. It would help with member communication and understanding of what appears to be anomalous treatment between two near-identical members. It would mean that administrators do not need to cater for a pitfall and have to have systems in place to spot such subtle differences and treat two such members differently.

The following is an example of the anomalies that arise. In both cases the members have drawn benefits from another scheme first which has already used up some of their Lifetime Allowance (LTA):

- Member A has a right to draw from a scheme a pension of £20,500 pa of which £500 pa counts as excess of the LTA so attracts an LTA tax charge. His benefit started to accrue a little before April 1997, and more than £500 pa was "pre 1997 but not GMP".

- Member B is identical except that his service started after 1997 so all his £20,500 is Section 9(2B) rights.

Member A can have the £500 pa excess as pension or cash, whereas Member B can only have pension – why?

At the extreme, Member A and B in the case above could have had just the £500 pa benefit in the scheme, all of it above the LTA because of benefits already drawn elsewhere. It might be that the scheme is forced to administer this benefit on-going for Member B solely because of the block in the current legislation.

The change to the regulations would be simple – just to add the LTAXS to the list in 19 and 31.

<u>Regulations 33 and 34:</u>

These regulations replicate regulations 69A and 69B in the 1996 Contracting Out regulations on GMP conversion (and, in that sense, are unobjectionable in that the status quo is preserved). However, we think that the opportunity should be taken to improve these regulations to make them more appropriate for future GMP conversion exercises. For example, regulation 33(3)(c) gives the trustees an open-ended option of revisiting the assumptions 'if they later think it is necessary'. Since the appropriate choice of assumptions is bound to change over time, that would seem to require trustees to revisit the assumptions (and hence the conversion) repeatedly (although this cannot be the policy intention). For example, if the trustees in good faith selected a long-run inflation assumption of 3% pa, based on market indicators at the time of the conversion, and it transpires that seven years later inflation has remained persistently above 5% pa, it would create truly formidable difficulties should the wording remain as per the current regulations. Sets of assumptions need to be selected "in the round" but nevertheless, we anticipate real difficulties and either unnecessary work in re-justifying the chosen basis, or, worse, a need to revisit the whole set of calculations.

You will be aware of the work that is being carried out by the GMP Conversion Working Group and in particular proposals to adjust aspects of Sections 24A to 24H of the Pension Schemes Act 1993 in order that technical issues beyond adjusting for GMP inequalities can be addressed. We ask that you make these adjustments through amendments to the Pension Schemes Bill currently before Parliament along the lines of the detailed proposals sent to you by the National Association of Pension Funds on 22 May 2014. We would then request a number of amendments to Regulations 33 and 34.

Question 28*: In addition to the amendments to the legislation set out in this document, is there any further legislation that you believe should be revoked or amended in order to meet the intention of preservation of accrued contracted-out rights?*

We note that paragraph 13(3)(a) in schedule 3 of the 1996 Contracting Out Regulations requires the actuary to assume that the earner leaves pensionable service three years after the effective date (or normal pension age if sooner). This should presumably be amended to reflect the fact that three years may now extend beyond the 'second abolition date' in April 2016. In such a case, we would expect the comparison between scheme benefits and the reference scheme to be made over the period to April 2016. We suggest that you make this change in Regulation 35 as it relates to a certification issue taking place before 6 April 2016.

We are not aware of any further legislation that requires revocation or amendment. However, this is a question that is best addressed to pension lawyers.

***Question 29**: What changes to scheme rules will trustees be obliged to make to ensure their scheme rules continues to have the same effect as a result of the abolition of contracting-out and the introduction of the single-tier pension?*

As with the previous questions, we think this is a question best addressed by pension lawyers. However, there may be an argument for enabling trustees to amend their scheme rules by resolution in certain circumstances. Many pension schemes will have rules which set out some sort of integration with the existing state pension system, whether in terms of deductions to pensionable or contribution salary, offsets in the definition of accrual or the period over which temporary 'bridging' pensions are payable.

We understand that, following April 2016, definitions such as 'basic state pension' and 'additional state pension' will continue to exist in legislation (as there will still be individuals in receipt of them), so, where scheme rules refer explicitly to these legislative definitions, the rules will continue to have the same effect. However, trustees and employers in such cases might prefer to recast their scheme rules in order to achieve integration with the new single tier state pension. In most cases, they will be able to do so under scheme rules, but there might be a need for an override power (exercisable by the trustees with the agreement of the employer) to enable amendment in such cases where the scheme rules to do otherwise allow.

There are, however, also scheme rules where the reference may simply be to 'state pension' or 'state retirement pension', and it then becomes a matter of interpretation whether this is a reference to the existing basic state pension or to the new single tier state pension (or whether the reference becomes simply undefined). This interpretation of such terms could lead to quite perverse results: in the event that an offset to salary is now interpreted as being the larger single tier amount rather than the basic state pension, the application of a higher offset could even lead to benefits being reduced. Legislation will be needed to ensure that trustees are able to amend their rules in order to clarify the definition that they are using.

There may also be a need for exemptions from section 67 of the Pensions Act 1995 for changes which aim at restoring the pre-April 2016 position (where scheme rules are interpreted as introducing a reference to the new single tier pension and the trustees wish to reinstate the old definition of basic state pension).

Finally, some schemes will have it written into their rules that the reference scheme test benefits act as an underpin. There may be a need for a trustee modification power in cases where trustees cannot otherwise remove this requirement.

About the Association of Consulting Actuaries (ACA)

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and all actuarial advice given is subject to the Actuaries' Code. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of private sector defined benefit pension schemes.

The ACA is the representative body for UK consulting actuaries, whilst the Institute and Faculty of Actuaries is the professional body.

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