ASSOCIATION OF
aca
CONSULTING ACTUARIES

St Clement's House, 27-28 Clement's Lane, London EC4N 7AE
Tel: +44 (0)20 3207 9380 Fax: +44 (0)20 3207 9134 EMail: acahelp@aca.org.uk
Web: www.aca.org.uk

20th October 2010 – *updating and replacing letter of 20 October 2010*

Neil Vosper / Uzair Farooq
Department for Work and Pensions
7th Floor
Caxton House
Tothill Street
London SW1H 9NA

Dear Sirs

Abolition of contracting out on a defined contribution basis: consultation on draft consequential legislation

I am writing on behalf of the Association of Consulting Actuaries in response to your consultation on the above legislation.

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 are subject to the code of professional conduct of the Actuarial Profession. 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 effectively the 'trade association' for consulting actuaries, whilst the Institute and Faculty of Actuaries is the professional body.

Transfers issue

The most important issue that has been causing significant difficulties is the ability to transfer contracted out benefits from schemes contracted out on the defined benefit (salary related) basis.

We wrote to you on this issue on 7 September 2010. I attach our letter on this and Christopher Evans' response from the DWP.

As a reminder, our concerns on transfers included the following:

- This intent would seem to go against very longstanding statutory rights for such members to transfer their benefits, if they so wish, and would be against the spirit of portability

- There would be an inequity between the options for members with benefits contracted out on a DB basis and on a DC basis

- Publicity about the change means that there could be a massive rush from members to transfer benefits before April 2012, which might be at a time and on terms that might well not be suitable for members

Contracted-out benefits include GMPs and Section 9(2B) rights – for members who joined their scheme after 1997, their total benefits could be 100% contracted out, potentially trapping members' benefits in inappropriate arrangements for them. The option to transfer to another defined benefit pension scheme is not available to most in the private sector, as employees are typically not offered defined benefit pensions. Those DB schemes that exist in the private sector have almost all chosen not to accept transfers in, typically because of concerns that the unresolved sex equalisation of GMPs means that the scheme may be taking on a larger liability than expected.

As currently, members would not be obliged to transfer their rights; they would only do so if they wished to. It is currently permissible for DB scheme members to transfer their contracted out rights to DC contracted-out arrangements. In doing so, they voluntarily give up their right to a guaranteed benefit. They are subject to the same uncertainty of investment markets as applies to all other DC arrangements. The "protection" that they retain is that they must buy a unisex annuity at retirement, which carries rights to pension increases and a spouse's pension. As the cost of these annuities is set by the insurance market, even this cannot really be described as protection.

Transferring rights to a DC arrangement is not for everyone. However there are those who transfer because they reasonably expect to receive a DC pension that is better suited to their situation. These people include:

- those who through poor health or lifestyle can obtain enhanced annuity terms;

- members who have no spouse and so have no use for the spouse's benefits typically provided by a DB scheme;

- those who wish to start their pension before their pension age, where this is not permitted by their DB scheme rules.

One option that could provide some protection against inappropriate transfers may be for members to have to make declarations as they would currently for overseas transfers of contracted out benefits (see The Contracting-out (Transfer and Transfer Payment) Regulations 1996 (SI 1996/1462) Regulations 6 and 11).

DB schemes that have contracted out on the DC basis

We understand that certain Protected Rights requirements must be written into scheme rules in order to meet the money purchase contracting-out conditions.

Therefore to achieve the full benefits of this simplification trustees of contracted-out money purchase schemes will need to modify their scheme rules (eg on such matters as combining money purchase pots for investment purposes, removing ineffective underpins from defined benefit schemes that have contracted-out on a money purchase basis and eliminating unnecessary restrictions on the shape of benefits when they are taken).

It is not clear whether trustees would be able to remove redundant Protected Rights clauses post abolition. Potential difficulties may include Section 67 of the Pensions Act 1995 and the Employer consultation requirements (if withdrawal of Protected Rights were to be deemed to be within a listed change under these requirements).

We would suggest therefore that legislation is made clear that such changes would not fall foul of Section 67 of the Pensions Act 1995 or come under the employee consultation requirements under the Pensions Act 2004.

Other comments

Other measures being proposed are of more of an administrative nature, and seem sensible to us. The few comments we have are set out in the Appendix and essentially relate to:

- Communications
- Status of schemes that wish to contract out on the salary related basis from 2012.

Many of the questions in the consultation concern whether the drafting of the Regulations achieve the stated objectives. We are generally comfortable with the stated objectives, but we are not in a position to comment on the legal effect of wording.

We hope that you find our comments of assistance, and would be happy to discuss this potentially very significant issue. You can contact me on 020 7082 6228 (charles.young@hymans.co.uk) or my colleague Spencer Bowman on 020 7227 2170 (Spencer.Bowman@towerswatson.com).

Yours sincerely

Charles Young
Chairman, Pension Schemes Committee

Enclosures:

1 Letter to the DWP dated 7 September 2010
2 Response to letter by Christopher Evans dated 9 September 2010

Abolition of contracting out on a defined contribution basis: consultation on draft consequential legislation

Question 1
In considering the draft legislation, are you satisfied that the remaining provisions adequately allow for 'tidying up' post abolition – in particular has any legislation been revoked which you consider needs to be retained? Conversely, is there anything that has been retained which you think needs to be revoked?

Several schemes that are contracted out on a COMP basis were contracted out on the GMP basis prior to 1997 and may wish to be contracted out on the salary related basis post 2012. It is not absolutely clear to us that schemes will be able to switch in 2012 under the legislation.

There is no legislation that we are aware of that should be retained post 2015.

Question 2
The draft legislation has sought to remove references to contracted-out mixed benefits schemes as only salary related schemes can continue to be contracted-out after April 2012. Is the removal of these references sufficient for schemes to be aware that any contracting-out certificate issued to a mixed benefit scheme will remain valid only on a salary related basis after April 2012?

This seems reasonably clear where sections cease to contract out on the COMB basis. However, it would be helpful if the HMRC were to issue a notice to each COMB scheme to confirm the ongoing basis of contracting out under the scheme, and to summarize the new requirements that flow from this, with links to more detail information on the DWP or HMRC website, for example.

We anticipate that many COMB schemes would wish to switch contracted-out money purchase sections to a COSR basis. How does the HMRC expect this process to work?

Question 3
Do you agree that this information requirement will not add to the cost that schemes expect to incur as a result of communicating with their members in relation to abolition of defined contribution contracting out?

We agree ceasing (or changing) contracting-out status will need to be explained to members. Additional costs would of course result: no notification would have been necessary had the government not chosen to make the change. There will also be one off changes to administration systems, to disapply the sections that deal with current contracted-out requirements. However, we agree that these particular minimum requirements would not lead to material additional requirements to those that would be required following any change, and the resulting simplification will be more attractive in the longer term.

It would be useful for the DWP or HMRC to provide standardised notifications that can be used as precedents by schemes and employers, so that all affected employees can receive consistent information.

Question 4
As from the abolition date, protected rights (derived from rebated national insurance contributions) will no longer exist. The existing restrictions on the transfer of funds currently comprising protected rights will no longer be in place after 6 April 2012 – is it clear from the amendments made by regulations 5 and 6 that this is the case?

We are satisfied that restrictions on transfers of protected rights would be removed, but we would say that we are not legal advisers.

However, we reiterate that we have written to you previously that the proposed prohibition of transfers of contracted out benefits to dc arrangements from 2012 is highly undesirable, and we strongly encourage the DWP to change this proposal.

Question 5
You are asked to comment on whether you consider that the draft Statutory Instruments set out in the Annexes will end contracting-out on a defined contribution basis, whilst still allowing for any rebate payments/recoveries to be made after 6 April 2012.

As stated in the body of this letter, we understand that certain Protected Rights requirements must be written into scheme rules in order to meet the money purchase contracting-out conditions.

Therefore to achieve the full benefits of this simplification trustees of contracted-out money purchase schemes will need to modify their scheme rules (eg on such matters as combining money purchase pots for investment purposes, removing ineffective underpins from defined benefit schemes that have contracted-out on a money purchase basis and eliminating unnecessary restrictions on the shape of benefits when they are taken).

It is not clear whether trustees would be able to remove redundant Protected Rights clauses post abolition. Potential difficulties may include Section 67 of the Pensions Act 1995 and the Employer consultation requirements (if withdrawal of Protected Rights were to be deemed to be within a listed change under these requirements).

We would suggest therefore that legislation is made clear that such changes would not fall foul of Section 67 of the Pensions Act 1995 or come under the employee consultation requirements under the Pensions Act 2004.

Further comments on disclosures

- We note that the members of appropriate and occupational pension schemes must be informed within 4 weeks/one month of 6 April 2012 and provided further information within 4 months - The Pensions Act 2007 (Abolition of Contracting-out for Defined Contribution Pension Schemes)(Consequential amendments) Regulations 2011 paragraphs 2(5)(c) and 8(2).

  This could be a major undertaking for providers and trustees. Many would wish to make the notifications before 6 April 2012 if they can without the requirement to repeat the communication after 6 April 2012.

- We note that there is to be a statement that members are to be informed that "as a result of no longer being a member of a contracted-out scheme, the member will build up entitlement to an additional state pension from that date." paragraph 2(7)(c) and 8(c).

  This would not automatically be the case, depending on earnings and possibly being contracted out on the salary related basis going forward.