Title: Abolition of contracting-out for defined contribution pension schemes **Lead department or agency: DWP** **Other departments or agencies: HMRC**	Impact Assessment (IA)
	IA No: DWP0015
	Date: 5 May 2011
	Stage: Final Proposal
	Source of intervention: Domestic
	Type of measure: Secondary Legislation
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Summary: Intervention and Options

What is the problem under consideration? Why is government intervention necessary?

The Pensions Commission (an independent commission) recommended in 2005 abolishing contracting-out for occupational, personal and stakeholder pension schemes that contract out of the State Second Pension on a defined contribution (DC) basis. Under contracting-out, individuals receive a rebate of their National Insurance contributions which is paid into their pension fund. In return they do not build any entitlement to the State Second Pension, the earnings-related component of state pension provision. The Commission's view was that the contracted-out/contracted-in choice added complexity to the UK pension system and was poorly understood by individuals. Its application to personal pensions had added to the pension mis-selling problems of the 1990s. The then Government accepted the Commission's recommendations (indeed there was broad political and stakeholder consensus) and the Pensions Act 2007 provided for the abolition of contracting-out on a defined contribution basis as part of a wider reform of both state and private pensions. The 2007 Act repealed the primary legislation relating to contracting-out on a DC basis from a future abolition date. A ministerial statement was made in March 2010 confirming that the abolition date would be 6^{th} April 2012. Regulations are therefore being introduced to make the necessary consequential and supplemental changes to secondary legislation where there will no longer be any supporting primary legislation. In addition the regulations are also making some minor changes to primary and secondary legislation to allow for a transitional period to deal with late or adjusted National Insurance rebate payments.

What are the policy objectives and the intended effects?

Abolition of contracting-out on a defined contribution basis will:
- provide greater clarity for individuals in their savings decisions and more flexibility in how they shape their retirement income. There will be only one set of rules covering the whole of a person’s pension savings and they will be able to choose an annuity most suited to their circumstances;
- remove the difficult judgement that individuals currently have to make about whether they would be better off contracted-in or contracted-out of the State Second Pension;
- allow individuals to make more informed decisions about their additional pension saving options by building on a clear foundation from the State;
- remove some of the administrative burdens placed on schemes by having to adhere to different rules concerning protected rights. This reduction in the administrative burden will provide some annual savings for schemes/pension providers.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

The policy options considered in relation to contracting-out were outlined in the Regulatory Impact Assessment accompanying the Pensions Act 2007:

- Option 1: do nothing: under this option individuals would continue to be able to contract-out of the State Second Pension through a DC arrangement. The regulatory burden on schemes would be left unchecked. Nothing would be done to simplify the saving decision for individuals.
- Option 2: simplify contracting-out: under this option there would be a package of proposals, including the abolition of DC contracting-out. Members of DC contracted-out schemes will start to accrue full rights to the State Second Pension and not have to make a complicated decision on whether to contract out or in.

No new consideration is being made in relation to these options in this updated impact assessment.

When will the policy be reviewed to establish its impact and the extent to which the policy objectives have been achieved?	The transitional arrangements will be reviewed in October 2013
Are there arrangements in place that will allow a systematic collection of	No

monitoring information for future policy review?	

Sign-off For enactment stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister: Date: 05/05/2011

Summary: Analysis and Evidence

Policy Option 1

Description: Policy option 1: Simplify contracting-out

Price Base Year 2010	PV Base Year 2012	Time Period Years 48	Net Benefit (Present Value (PV)) (£bn)		
			Low: N/A	High: N/A	Best Estimate: 0.140

COSTS (£bn)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	0.0058		2.3	**51.0**

Description and scale of key monetised costs by 'main affected groups'

The cost of this policy is on employers sponsoring contracted-out occupational DC schemes and individuals in DC pensions (both occupational and personal). Employers see a 1.4 percentage point increase in their National Insurance contributions on employee earnings between the Lower Earnings Limit and the Upper Accrual Point. Of the £51 billion present value of the total cost, around £1 billion relates to the total cost to employers.
Individuals see an increase in their National Insurance contributions on the same band of earnings, although this takes the form of the reduced National Insurance contributions no longer being paid into their private pension scheme. The vast majority of the rebate goes to individuals so the main cost of the policy falls on them. Of the £51 billion present value of the total cost, around £50 billion relates to the total cost to individuals.
There is also a small one-off cost of £5.8 million to employers and DC pension administrators of converting to contracted-in status. This includes the costs of changes to IT systems, member communications and payroll systems in the case of occupational DC schemes.

Other key non-monetised costs by 'main affected groups'

An indirect impact of the policy is that it reduces the amount of financial assets in the private pension system. Scheme administrators and fund managers levy charges on funds under management and will therefore see a reduction in income, which could build up to a significant amount over time. Charging practices are commercially sensitive and there is therefore no reliable data available with which to estimate this secondary impact.

BENEFITS(£bn)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	0		3.3	**51.14**

Description and scale of key monetised benefits by 'main affected groups'

Sponsoring employers are required under current legislation to pay the 1.4 per cent National Insurance rebate into their scheme. Once contracting-out for DC schemes is abolished, they will no longer be required to do this and it is assumed that they will end this minimum payment. Of the £51.14 billion present value of the total benefit, around £1 billion relates to the total benefit to employers. Taking into account costs and benefits, the impact on sponsoring employers will be neutral.
Individuals will, following abolition, receive State Second Pension (S2P) in retirement as a result of being contracted in. Contracting-out is designed to be actuarially neutral, so the amount of S2P gained is expected to be equivalent to the pension that would be derived from the rebate that is given up. The overall impact on the individual is therefore neutral in the long term as they simply swap part of their private provision for state provision. The overall cost for individuals of making pension provision remains the same – the policy effectively moves their contributions from their private pension into the State Second Pension. Of the £51.14 billion present value of the total benefit, around £50 billion relates to the total benefit to individuals.
The abolition of DC contracting-out means the private pensions industry will no longer have to track 'protected rights' and there will be an annual administrative saving from this – estimated to be around £5.3 million a year on average (2010/11 prices). Of the £51.14 billion present value of the total benefit, around £130 million relates to this benefit.
Government will benefit from no longer having to administer the DC contracted-out rebate. The estimated savings from this are available up to 2019/20 and are estimated to be in the region of £2m per annum (2010/11 prices) over this period. The present value of these savings amounts to £15 million.

Other key non-monetised benefits by 'main affected groups'

Individuals benefit from the increased simplicity in their pension saving and retirement income decisions following the abolition of DC contracting-out and a higher state pension entitlement.

Key assumptions/sensitivities/risks	Discount rate (%)	3.5% real first 30 years 3.0% real subsequent years

The estimates are based on a counterfactual of the current state pension and contracting-out system continuing in its present form. Any future reforms of this system will alter the counterfactual and therefore the estimated value of costs and benefits.

Direct impact on business (Equivalent Annual) (£m):			In scope of OIOO?	Measure qualifies as
Costs: 0.25	Benefits: 5.51	Net: 5.26	Yes	OUT

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?			United Kingdom		
From what date will the policy be implemented?			6/4/2012		
Which organisation(s) will enforce the policy?			None		
What is the annual change in enforcement cost (£m)?			Nil		
Does enforcement comply with Hampton principles?			N/A		
Does implementation go beyond minimum EU requirements?			N/A		
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A		**Non-traded:** **N/A**
Does the proposal have an impact on competition?			No		
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?			**Costs:** 25%		**Benefits:** 25%
Annual cost (£m) per organisation (excl. Transition) (Constant Price)	**Micro** 0	**< 20** 0	**Small** 0	**Medium** 0	**Large** 0
Are any of these organisations exempt?	No	No	No	No	No

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

Please note this checklist is not intended to list each and every statutory consideration that departments should take into account when deciding which policy option to follow. It is the responsibility of departments to make sure that their duties are complied with.

Does your policy option/proposal have an impact on…?	Impact	Page ref within IA
Statutory equality duties[2] Statutory Equality Duties Impact Test guidance	Yes	Pages 12-14
Economic impacts		
Competition Competition Assessment Impact Test guidance	No	
Small firms Small Firms Impact Test guidance	No	
Environmental impacts		
Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance	No	
Wider environmental issues Wider Environmental Issues Impact Test guidance	No	
Social impacts		
Health and well-being Health and Well-being Impact Test guidance	No	
Human rights Human Rights Impact Test guidance	No	
Justice system Justice Impact Test guidance	No	
Rural proofing Rural Proofing Impact Test guidance	No	
Sustainable development Sustainable Development Impact Test guidance	No	

[2] Race, disability and gender Impact assessments are statutory requirements for relevant policies. Equality statutory requirements will be expanded 2011, once the Equality Bill comes into force. Statutory equality duties part of the Equality Bill apply to GB only. The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Evidence Base (for summary sheets) – Notes

Use this space to set out the relevant references, evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Please fill in **References** section.

References

Include the links to relevant legislation and publications, such as public impact assessment of earlier stages (e.g. Consultation, Final, Enactment).

No.	Legislation or publication
1	Pensions Commission Report: 2005: http://www.webarchive.org.uk/wayback/archive/20070801230000/http://www.pensionscommission.org.uk/publications/2005/annrep/main-report.pdf
2	The Pensions Act 2007: http://www.legislation.gov.uk/ukpga/2007/22/contents
3	Pensions Bill - Regulatory Impact Assessment: http://www.dwp.gov.uk/docs/pensions-bill-ria.pdf
4	Abolition of contracting-out on a defined contribution basis: consultation on draft consequential legislation: http://www.dwp.gov.uk/docs/abolition-contracting-out-dc-consultation.pdf
5	Abolition of contracting-out on a defined contribution basis – Government response to consultation on draft consequential legislation: http://www.dwp.gov.uk/docs/abolition-contracting-out-dc-response.pdf

Evidence Base

Annual profile of monetised costs and benefits* - (£bn) constant prices

The monetised costs in this section relate to: the estimated value of the increased National Insurance contributions due for those employers who sponsor occupational DC schemes and for individuals in occupational DC schemes and personal pension schemes; and the one-off transition costs for pension providers and schemes of converting to contracted-in status. The benefits are: the value of the minimum payment that no longer has to be made by the sponsoring employer once DC contracting-out has been ended (this is the same value as the increased employer National Insurance contributions); the additional State Second Pension expenditure which is received by individuals in exchange for the withdrawal of the contracting-out rebate; and the administrative savings to the private pensions industry and government arising from the abolition of DC contracting-out.

Note that the benefits appear low in comparison to the costs in early years. This is due to the timing effect outlined above – individuals give up their contracting-out rebate today and receive an equivalent amount of State Second Pension when they retire, much further into the future. In the long term, the impact on individuals will be neutral because contracting-out is designed to be neutral – rebate rates are set such that in expectation, the State Second Pension accrued from being contracted-in is equivalent to the private pension that would be derived from the contracted-out rebate. For employers sponsoring occupational DC schemes the impact is neutral from the very start of the policy – because their increased National Insurance contributions are exactly off-set by the fact that they no longer have to pay their National Insurance rebate into the scheme.

* For non-monetised benefits please see summary pages and main evidence base section

Microsoft Office Excel Worksheet

Evidence Base (for summary sheets)

The State pension system

1. Entitlement to the Basic State Pension is dependent on payment of National Insurance contributions (NICs). The Basic State Pension is a flat rate pension and full entitlement is gained by paying 30 qualifying years of National Insurance contributions.

2. There is also an earnings-related component of state pension provision, known as the State Second Pension (S2P) (formerly State Earnings Related Pension Scheme (SERPS) before 2002). Individuals build entitlement to this earnings-related component by paying the full rate of National Insurance contributions. The individual's entitlement is calculated on the basis of average lifetime earnings revalued to take account of increases in national average earnings.

Contracting-out of the earnings-related element of state pension from 1978

3. The concept of contracting-out (leaving the earnings-related element of the state pension system) under the State Earnings Related Pension Scheme (SERPS)[3] was that in return for providing pension benefits broadly equivalent to the benefits payable under SERPS, lower National Insurance contributions were payable by the employer and employee.

4. Initially, (from 1978) an individual could only be contracted-out if they were a member of a defined benefit occupational pension scheme. However, from 1988, defined contribution occupational pension schemes that satisfied various conditions were permitted to contract members out of the earnings-related state pension. Members of occupational defined contribution schemes and their employers received a rebate on their National Insurance contributions which had to be paid into the member's pension fund.

5. Since 1988, individual employees have been permitted to contract-out of SERPS by contributing to a personal pension scheme and from 2002 into a stakeholder pension scheme, provided that various conditions were met. Members of personal pension schemes pay full rate National Insurance but at the end of the tax year, a rebate is paid into the member's personal pension scheme.

6. Contracting-out is designed to be actuarially neutral, so the amount of State Second Pension for a contracted-in individual is expected to be equivalent to the private pension that would be derived from the rebate for a contracted-out individual. The individual should therefore be neutral between being contracted-in and being contracted-out.

Abolition of contracting-out through defined contribution pensions

7. DC contracting-out commenced in 1988[4]. This was during a sustained period of strong equity market returns, and at a time when free markets and investing were extremely fashionable – the real return on equity investments between 1981 and 1986 was in excess of 20 per cent per annum.

8. Since it was introduced, the number of members who are contracted-out has steadily declined from a peak of 4.7m in 1992 to 1.9m in 2008/09, despite growth in DC pensions resulting from the decline of Defined Benefit pensions.

9. Over the last decade many pension providers have either contracted members back-in, written to members to inform them they will be contracted-back in unless they opt-out, or

[3] In 2002, SERPS was replaced by the State Second Pension (S2P).
[4] It was introduced in legislation in the 1986 Social Security Act

suggested members should contract back-in. This is because many providers were concerned that members could expect to be better off financially from being contracted-in than being contracted out[5], and considered that there could be future accusations that providers were not fulfilling a perceived duty of care - and possibly be liable for financial sanction - if they did not take steps to at least inform members of this. Some providers felt they should go further.

10. In 2005, an independent Pensions Commission, chaired by Lord Turner, recommended the abolition of contracting-out on a defined contribution (DC) basis. The Commission's view was that the contracting-out/contracting-in choice added complexity to the UK pension system and was poorly understood. Its application to personal pensions helped generate the pensions mis-selling problems of the 1990s. The Government accepted the Commission's recommendation and the Pensions Act 2007 provided for abolition. During the passage of the legislation there was widespread support in Parliament for abolition. In March 2010, the Government announced that abolition would be on 6 April 2012, and that date has been confirmed by the present Government.

11. The rationale for change and the options for reform are described in detail in the regulatory impact assessment for the Pensions Act 2007. That assessment also covered the wider pension reform agenda including work place pension reform and reducing the number of qualifying years for receipt of basic state pension. The impact assessment is available from: http://www.dwp.gov.uk/docs/pensions-bill-ria.pdf

12. The collective term for the National Insurance rebate, associated tax relief and investment return that accrued whilst contracted-out is 'protected rights'. Under the current DC contracting-out system, there are special rules relating to protected rights which abolition will remove. These rules include:

- restrictions on the type of scheme in which protected rights can be invested or to which they can be transferred;
- a requirement to purchase a unisex annuity; and
- a requirement to make provision for a survivor benefit where the member is married or in a civil partnership at the point of annuitisation.

13. Abolition of contracting-out on a defined contribution basis will:

- provide greater clarity for individuals in their savings decisions and more flexibility in how they shape their retirement income. There will be only one set of rules covering the whole of a person's pension savings and they will be able to choose an annuity most suited to their circumstances;
- remove the difficult judgment that individuals currently have to make about whether they would be better off contracted-in or contracted-out of the State Second Pension;
- allow individuals to make more informed decisions about their additional pension saving options by building on a clear foundation from the State;
- will remove some of the administrative burdens placed on schemes by having to adhere to different rules concerning protected rights.

[5] Particularly as since the late 1990s there has been a cap on rebate rates, which is currently set at age 44, such that for people above this age being contracted-in is a better than neutral outcome.

Costs and benefits: impacts on affected groups

14. For summary purposes, the table below breaks down the present value of the costs and benefits on page 3 by employers, individuals, schemes and government. Further description of these costs and benefits is provided in the sections below:

Table 1: Present value of monetised policy costs and benefits 2012-2060

	Costs		**Benefits**	
	£bn, pv terms	**Reason**	**£bn, pv terms**	**Reason**
Employers	1	Increased National Insurance contributions	1	No longer required to pay rebate into pension scheme
Individuals	50	Increased National Insurance contributions/reduction in private pension assets	50	Receipt of State Second Pension/reduction in individuals' private pension contributions
Schemes/industry	-	-	0.13	Administrative saving from no longer having to track contracted out DC rights
Government	-	-	0.015	Administrative saving from no longer having to administer DC contracting out.
Total	**51**	**-**	**51.14**	**-**

Impact on individuals, employers and the financial services sector

15. Under DC contracting-out, the employer and individual receive a rebate of National Insurance contributions which are then paid into the individual's private pension fund. In return for this rebate the individual foregoes building entitlement to the State Second Pension, a state-provided, earnings-related pension. Rebate rates are set in an actuarially neutral fashion, such that they cover the expected cost of providing the State Second Pension through the individual's private pension. When taking their pension income, individuals are required to adhere to certain rules about how they shape their rebate-derived pension income (e.g. they must purchase an inflation-linked annuity, they must make a provision for a survivor). The individual currently has a choice over whether they wish to be contracted out in this way or not.

16. The benefits of this system to the individual are that they receive additional money in their private pension fund today in lieu of a stream of payments from the State many years into the future. However, a consequence of the deal is that they bear the risk of their private pension underperforming, and providing less than the state scheme would provide. Although in expectation[6], individuals should be left unaffected by whether they are contracted in or out, in practice, there will be a wide range of outcomes from having contracted out – compared to being contracted-in into the State Second Pension, some people will do better, some will do worse and some will be neutral. It is not possible to monetise the value of this

[6] Given the actuarial neutrality of rebate rates.

choice to the individual – its value is purely down to individual preference over whether to be contracted in or out. Some people will prefer having the money in their pension today and will be happy to bear the risk of their fund performing badly; others will prefer to give up the money today in return for the greater certainty of the State scheme.

17. To the extent that this choice is removed once DC contracting-out is abolished, there is a restriction on individual choice relative to the current system. However, the Government believe the benefits to individuals are greater for a number of reasons, some of which were also articulated by Lord Turner's Pensions Commission[7], an independent commission set up in December 2002, with the remit of keeping under review the adequacy of private pension saving in the UK, and advising on appropriate policy changes:

- The choice over whether to contract out or not has added complexity to the UK pension system and is poorly understood. Its application to personal pensions helped generate the pensions mis-selling problems of the 1990s.
- By contracting back in to the State Second Pension, individuals pass the risk of uncertainty in their DC pension income onto the State, which provides them with a more certain, earnings related pension in retirement.
- Having a more certain component of state pension in their overall pension income could aid the saving decision for individuals. By receiving a greater fraction of their pension income through the State, the individual now needs to make lower levels of private pension contributions in order to reach a given level of pension income.

18. For these reasons, Parliament, when passing the 2007 Pensions Act, believed the restriction on individual choice brought about by the ending of DC contracting-out was justifiable and indeed beneficial to individuals. The Government fully supports this decision. The fact that the numbers contracting out in a DC pension has been in steady decline from a peak of 4.7 million contracted-out DC arrangements in 1992 to 1.9 million in 2008/09[8], suggests that individuals place greater value on the certainty of the State Second Pension in comparison to the contracted-out rebate.

19. With the abolition of DC contracting already having been legislated for in 2007, many individuals may not have made any further decisions on whether to contract in or out – knowledge that the choice is being removed from 2012, coupled with inertia, means some people will simply not take any action either way.

20. The regulatory impact assessment for the Pensions Act 2007 estimated that the rebate for DC schemes (both personal pension and occupational DC pension schemes) amounted to £3.5 billion (in cash terms) in 2003/04. That figure is now forecast by HMRC to be around £2.6 billion (in cash terms) by 2011/12; the main reason for it being lower is that fewer people are now contracted-out.

21. The contracting-out rebate is set by the DWP Secretary of State, based on calculations by the Government Actuary, to be actuarially neutral, and is based on the expected cost, given prudent assumptions on investment returns, of providing a private pension equivalent to the State Second Pension foregone. The actuarial neutrality of rebate rates[9] ensures that the individual is, in expected value terms, unaffected by whether they are contracted in or contracted out. So abolishing DC contracting-out and contracting the individual back in to the State Second Pension means that the expected impact on the individual is neutral in financial terms. This is shown in table 1, which contains the costs and benefits of the policy to individuals – the present value of increased National Insurance contributions over the

[7] 'A New Pension Settlement for the Twenty-First Century: The Second Report of the Pensions Commission', 2005
[8] Source: Second Tier Pension Provision statistics.
[9] Since the late 1990s, rebate rates, which are age specific, have been capped below the actuarially neutral level for some age groups. Rates have been capped for people above the age of 44, such that for this group, being contracted into the State Second Pension represents a better than neutral outcome.

period to 2060 is exactly equal to the increased State Second Pension expenditure which goes to individuals. Costs appear greater than benefits in the early years because National Insurance rises in the short term, but the benefit of additional State Second Pension entitlement does not begin until retirement. However, in the long run, the effect will be neutral for the individual.

22. In effect, abolishing contracting-out means that individuals simply exchange part of their private pension for some additional state pension. The overall cost for individuals of making pension provision remains the same – the policy effectively moves their contributions from their private pension into the State Second Pension. Therefore removal of the rebate will result in a lower private pension but that difference will be made up by a similar increase in the State Second Pension in the long run.

23. The main non-monetised benefit for individuals is having greater control over their private pension fund, through no longer having to abide by the protected rights rules, which govern what they must do with the contracted-out element of their pension fund. Individuals will be able to make decumulation decisions that suit them best, without prescription from the State. Individuals will also face a simpler state pension system, with the complexity around the contracting-in/out decision removed.

24. For employers sponsoring contracted-out occupational DC schemes, there will be an increase in National Insurance contributions of 1.4 percentage points on employee earnings between the Lower Earnings Limit and the Upper Accrual Point. However, the current legislation states that the employer must pay this amount into the pension scheme on the member's behalf. Removal of the rebate also means removal of the requirement to make that contribution to the scheme so again the effect on employers will be cost neutral, assuming that they no longer make the minimum payment. Furthermore, very little of the total rebate goes to sponsors of contracted-out occupational DC schemes - just 8 per cent of active contracted-out DC membership is in occupational schemes[10] - so the vast majority of the impact is on individuals with personal pensions rather than employers.

25. The figures under the costs and benefits in the summary of analysis and evidence on page 3 above also include these off-setting National Insurance and minimum payment figures respectively. These, like the figures for individuals discussed in paragraph 18 above, are based on internal DWP forecasts. These are based on the same methodology as the 2006 forecasts that accompanied the production of the 2007 Pensions Act regulatory impact assessment, but updated for more recent trends in DC contracted-out membership.

26. To capture the full effects of this policy change the impact assessment covers the period 2012 to 2060 - because it is only over such a long period that the benefits to individuals of increased State Second Pension payments will be realised. Over the period 2012-2060, the average annual cost of the DC rebate in the counterfactual[11] is estimated to be £2.3 billion (2010/11 prices). The present value of the annual cash flows to 2060 is £51.0 billion (2010/11 prices). This is the same for both the cost of the increased National Insurance contributions for employers and individuals, and the benefit of the ending of the minimum payment for employers, along with the increased State Second Pension for individuals. In aggregate, the impact is neutral.

27. An indirect impact of the policy is that it reduces the amount of financial assets in the private pension system. Scheme administrators and fund managers levy charges on funds under management and will therefore see a reduction in income, following the withdrawal of the contracting-out rebate from individuals, which could build up to a significant amount over

[10] Source: Second Tier Pension Provision statistics.
[11] In order to assess the impact of ending DC contracting-out, a counterfactual is required – in this case, the current system of DC contracting-out. The impact of ending DC contracting-out is then measured in relation to what would have happened if it had continued in its current form.

time. This loss should be off-set to a small extent by the small gains from the reduced administration costs discussed in paragraph 35.

28. When an individual, or group of individuals, cease to be contracted out, the rebate will simply stop being paid into their pension fund – it is not the case that a provider would have to close down a particular contracted-out product. Despite urging members to contract back into the State Second Pension and no longer actively marketing contracting-out, anecdotal evidence suggests providers continue to offer the option to contract out on the grounds of customer service.

29. To put the scale of DC contracting-out into perspective, the annual DC contracted-out rebate is around £2.6bn, compared to total assets of DC schemes of £470bn - £965bn[12] which means the contracted-out rebate is worth 0.3 - 0.6% of total DC assets.

30. The pensions industry may be able to make a profit from managing this additional £2.6bn per year. However, it is not known what amount of profit the industry would make from this as despite consulting with industry, industry are unable to provide us with an estimate of their profit margin. This is because the information is commercially sensitive, and it is also difficult to isolate and attribute profit arising from contracted-out funds alone, as the funds are processed and managed alongside employer and employee pension contributions as part of the overall pension fund. That the cost will be small is reinforced by the observation that as well as some providers deciding to contract members back in, one major provider also exited the contracting-out market for new members in recent years, further supporting the conclusion that profits from providing contracted-out benefits are small.

31. That the cost will be minimal is further supported by the response to our consultation[13]. The consultation raised the issue of the impact of abolition on the insurance industry and other firms managing contracted-out pension funds - we invited views specifically on this issue. A number of pension providers commented on abolition but none of the respondents commented directly on the loss of funds under management. As is clear from the industry views during the consultation (a selection of which are shown below), there was a lack of concern over the abolition of DC contracting-out.

The National Association of Pension Funds:

"We are pleased that the Government has recognised the additional complexity contracting out poses to schemes and that it can act as a barrier to saving. We therefore welcome the Government decision to abolish contracting out for defined contribution schemes from 2012."

Scottish Widows:

"While the abolition of money purchase contracting out removes a source of funded private pension saving it (abolition) is, on balance, a desirable step. The current structure and level of contracting out rebates are such that Scottish Widows, and many other pension providers, have taken action to urge individuals to contract back in to S2P. As such the abolition of money purchase contracting out largely reflects what is already happening."

HBOS (another large provider):

"HBOS supports the proposal to abolish contracting out into defined contribution schemes. From consumers' perspective the rebate rate is now either neutral or low and it will generally be either to their advantage to contract back in or very hard to make the decision."

[12] ABI Money in funded pensions, 2010
[13] Security in Retirement: towards a new pensions system May 2006
http://www.dwp.gov.uk/policy/pensions%2Dreform/security%2Din%2Dretirement/

Other key industry representative bodies, the Association of British Insurers and the CBI did not indicate any concerns in relation to either abolition or loss of profits in their responses.

32. The impact on scheme administrators and fund managers is considered to be second order because the reduction in income comes about from the fact that individuals receive less money to go into their private pension fund. The direct impact therefore falls on individuals with the impact on scheme administrators and fund managers being second order.

Impact on occupational and personal pension schemes

33. Following abolition, pension schemes will no longer be obliged to track DC contracted-out rights separately from other pension rights. This means that some administrative burdens will be removed from those schemes. In 2006, when the regulatory impact assessment was produced, it was not possible to assess how much of these administrative costs relate to the separate tracking of contracted-out rights and, when asked, scheme providers were themselves unable to quantify these costs. The Department has recently asked key pensions industry stakeholders if they are now able to quantify the costs of contracting-out and again they have responded in the negative.

34. However, PricewaterhouseCoopers (PwC), in a 2006 study[14], identified the cost of regulation relating to a large number of different policy areas, private pensions amongst them. PwC provided DWP with a detailed set of information of the costs of regulation that was identified as being relevant for private pensions, including those relating to contracting-out. The assessment of the administrative savings from this policy considered only those provisions which are relevant to contracting-out on a defined contribution basis. Within particular sets of regulations the assessment takes account of only those measures which relate to disclosure of information requirements. The estimate covers the total costs (in £ millions) associated with individual provisions and the total savings from their abolition. Some apportioning was necessary in respect of the Occupational Pension Schemes (Contracting-out) Regulations 1996 as these apply to both defined benefit (DB) and occupational DC contracted-out schemes. This was done on the basis of current active membership: contracted-out DB is around 7 million and occupational defined contribution is about 400,000[15] so approximately a 17:1 ratio. The PwC figures were estimated in 2006, since when there has been a 20 per cent decline in DC contracted-out membership; this assessment takes account of this.

35. Altogether the savings from the Pension Schemes Act 1993 and the relevant regulations being removed from 2012 totals around £5.3 million per annum in constant prices[16] (the original 2006 figures have been increased in line with the retail price index to take account of inflation since 2006). In the absence of any estimates from the private pensions industry, this has been assumed to be the annual saving to industry from abolition of DC contracting-out. Over the period to 2012-2060, which is the period under consideration in this impact assessment, the present value of these annual administrative savings is estimated to be £130 million (2010/11 prices).

36. There is a one-off cost of converting from a contracted-out to a contracted-in scheme. This includes: changes to the IT systems of pension providers; communications with individual members informing them of the move to contracted-in status and the implications of this; and, in the case of occupational schemes, changes to payroll systems to account for the increase in National Insurance contributions following abolition of contracting-out. The Department has asked industry stakeholders to provide information on these costs and has

[14] 'Administrative Burdens Measurement Exercise', PwC, 2006. Available to download from http://www.dwp.gov.uk/docs/adminburdens2.pdf
[15] Of the 1.9 million DC contracted-out arrangements, 400,000 are in occupational DC schemes, with the remainder in Personal Pensions.
[16] The cost of these regulations is £5.1 million today. A further two years of inflation (RPI is estimated by the Office for Budget Responsibility to be 3.6 per cent in 2011 and 3.0 per cent in 2012) means that these costs will be worth £5.3 million per annum in constant prices on the abolition of DC contracting-out in 2012.

received responses from The National Association of Pension Funds (NAPF) and the Association of British Insurers (ABI), which have asked their members for this information. Based on these discussions, the Department has been informed that a per-member cost of £3 in today's prices is a reasonable estimate of these one-off costs. Allowing for a further two years of inflation increases at 3.6 per cent in 2011 and 3.0 per cent in 2012[17] bring this to £3.20 on abolition in 2012. Based on there currently being 1.9 million contracted-out DC arrangements (see paragraph 15), the estimated one-off cost of converting to contracted-in status in 2012 is £6.1 million (£3.20*1.9 million) in cash terms. In today's prices (2010/11) this equates to a one-off cost of £5.8 million.

<u>Impact on the Exchequer</u>

37. The Exchequer will receive increased National Insurance (NI) revenue through not paying the NI rebates but will have to pay higher State Second Pension to those who have been put back into the State Second Pension. In the long term, increased benefit spending on State Second Pension will offset any early savings and the effect will be broadly neutral, with the main impact being one of timing; expenditure today being shifted into the future.

38. There is a small administrative saving to government from no longer having to administer DC contracting-out. Estimated savings are only available up to 2019/20 and are around £2 million per annum, on average (2010/11 prices). The present value of these savings over this period is around £15 million.

<u>Gender impacts</u>

39. In theory there could be a negative impact on women once the requirement to purchase a unisex annuity with protected rights is removed, since women should benefit more from a unisex annuity rate than a gender-specific annuity. This is because a unisex annuity rate will be based on both male and female rates, whereas under a gender-specific regime, females would receive a lower rate owing to their longer life expectancy[18]. This is a risk, but the Government believes that the benefits of getting rid of the protected rights rules outweigh this risk. Furthermore, the unisex annuity market is small – the Pensions Policy Institute estimate[19] that only 3% of the annuity market is comprised of unisex annuities. Any adverse impact will therefore be limited to a small proportion of annuity purchases.

40. By the same token, men who are currently required to purchase a unisex annuity will benefit from the protected rights rules being removed. They will be able to purchase a gender-specific annuity, which for them, will provide a superior rate compared to a unisex annuity.

<u>Consequential change to secondary legislation as a result of abolition of contracting-out on a defined contribution basis</u>

Background

41. The Government is making changes to secondary legislation which are essential in order to fully implement the primary legislative changes already agreed by Parliament for abolition. The secondary changes do not introduce new policy - instead they make changes that are consequential on abolition of contracting-out on a defined contribution basis. They remove rules and references that relate to DC contacting out from 6 April 2012, and introduce other provisions that will provide for a transitional period until 2015. A consequential change

[17] Source: Office for Budget Responsibility.
[18] On March 1st 2011, the European Court of Justice ruled that the use of gender as a risk factor in insurance contracts constituted discrimination. This will have implications for pensions annuity contracts in the future– it is expected that males and females of the same age will face annuity rates closer to the current female rates as a result of this ruling. The full implications of this ruling will become clear in the coming months.
[19] 'An analysis of unisex annuity rates', Pensions Policy Institute, 2004. Available to download from http://www.pensionspolicyinstitute.org.uk/uploadeddocuments/EOC_PPI_Unisex_Annuity_Report_June04.pdf

relates to transfers from contracted-out salary-related schemes (also known as defined benefit (DB) schemes) to non–contracted-out schemes.

42. Contracting-out is not being abolished for DB schemes. Legislation currently limits transfers only to other contracted-out schemes – from contracted-out DB schemes to contracted-out defined contribution schemes or vice versa. This is because special rules apply to contracted-out benefits, both in accrual and in payment. Currently, out of a total contracted-out DB membership of about 8 million (active and deferred members), there are about 46,000 transfers per annum to contracted-out DC schemes[20].

43. Following a public consultation, and consideration of the representations from the private pensions industry, DWP intends to introduce a more flexible approach to allow individual members the freedom to transfer from a contracted-out DB scheme to a non-contracted-out scheme following abolition. This will give individuals greater freedom and flexibility in shaping their retirement income to best suit their needs.

Impact on individuals and schemes

44. The provisions will provide more choice and flexibility for scheme members. They will, for example, be able to consolidate a number of small pension pots for a coherent retirement income. Members who transfer will no longer be required to make provision for a surviving spouse or civil partner but will retain the option to choose a joint life annuity. This could benefit members for whom the survivor benefit requirement might not be appropriate – for example if the spouse or partner has sufficient or better pension provision of their own. In some cases couples might prefer to have a higher starting pension during their early and more active years of retirement.

45. Scheme members will be required by law to consent in writing to a transfer and to acknowledge that they understand the implications of transferring, including that there will be no automatic provision for a survivor pension. They will be signposted to the relevant information available on annuity choice.

46. Schemes already have systems in place for transfers to non-contracted-out overseas arrangements. This additional flexibility will not impose any costs or savings on schemes.

Impact on survivors and equality impacts

47. Transferring from a contracted-out DB scheme will remove the requirement to provide for a 50% survivor pension for a spouse or civil partner. The survivor benefit rule reflects the fact that, had the scheme member not been contracted-out, a survivor would inherit 50% of their spouse/civil partner's additional state pension. The main impact of loss of the survivor benefit on transfer could be on widow/ers who have a broken work pattern and who have not built up state or private pension provision of their own. The risk is that a scheme member could choose a single-life annuity, leaving a survivor with little or no pension from the private pension scheme or from the additional state pension in respect of the years of contracting-out. According to data from the Association of British Insurers[21], around three-quarters of annuities are purchased with funds of less than £30,000, and 60 per cent of annuities are purchased with funds of less than £20,000. These represent total fund sizes and indicate that the average protected rights fund, which will be a sub-set of the total fund size, will be smaller. As an illustration, based on current annuity rates[22], a protected rights fund of £30,000 would buy around £17 a week in survivor benefit – so the impact should be limited.

[20] Source: HMRC
[21] ABI data on quarterly annuity sales by fund size is available from www.abi.org
[22] Source: FSA annuity tables, December 2010. Based on a 65 year old male purchasing a level annuity with a 50% survivor benefit.

48. A number of factors will mitigate the impact on survivors, who are for the most part women. Other provisions of the overall pensions reform package will result in women having better pension provision of their own and therefore reduce reliance on the survivor pension. For example, the state pension reform package will deliver a much fairer deal for women and carers by recognising working and caring contributions in the same way so more women will qualify for full state pension.

49. Increasing female participation in the labour force has led to more women having their own pension provision and, therefore, they are less reliant on a survivor benefit.[23] There has been significant growth in female labour market participation and a consequential growth in female pension provision. Female employment rates have gone up from 56% in 1971 to just under 70% today. Female pension provision has also increased over time, particularly amongst part time workers; in 1983 13% of female part time workers were members of their employer's pension scheme compared to just under 40% today; for full time female workers the membership has increased from around 55% of all female workers in 1983 to just under 60% today

50. Furthermore, as stated in paragraph 37 above, the member will have a choice over annuity provision - in some cases it will be appropriate to make provision for a partner but in other cases the overall household income could be higher by the purchase of a single life annuity. The policy allows for appropriate personal financial decisions to be made rather than those imposed by the state.

51. There is no evidence to suggest that any of the proposals in this Impact Assessment would have any impacts on other groups.

[23] The source for these figures is the ONS Pension Trends website http://www.statistics.gov.uk/pensiontrends/ .

Annexes

Annex 1 should be used to set out the Post Implementation Review Plan as detailed below. Further annexes may be added where the Specific Impact Tests yield information relevant to an overall understanding of policy options.

Annex 1: Post Implementation Review (PIR) Plan

A PIR should be undertaken, usually three to five years after implementation of the policy, but exceptionally a longer period may be more appropriate. A PIR should examine the extent to which the implemented regulations have achieved their objectives, assess their costs and benefits and identify whether they are having any unintended consequences. Please set out the PIR Plan as detailed below. If there is no plan to do a PIR please provide reasons below.

Basis of the review: [The basis of the review could be statutory (forming part of the legislation), it could be to review existing policy or there could be a political commitment to review]; The removal of all legislation relating to DC contracting-out will achieve the policy objective in that it will abolish contracting-out and individuals will no longer have to weigh the pros and cons for their private pension. It will also make pensions easier to explain. However, it is sensible to review whether the transitional arrangements are working satisfactorily, for both schemes and HMRC, and whether as a result any minor adjustment to the transitional legislation is required.
Review objective: [Is it intended as a proportionate check that regulation is operating as expected to tackle the problem of concern?; or as a wider exploration of the policy approach taken?; or as a link from policy objective to outcome?] As above the objective is to review the transitional arrangements before those arrangements cease to have effect and to introduce any changes that either HMRC or industry require.
Review approach and rationale: [e.g. describe here the review approach (in-depth evaluation, scope review of monitoring data, scan of stakeholder views, etc.) and the rationale that made choosing such an approach] In order to be effective the review would need to be carried out in the early days of the transitional period but long enough into it to have made a real assessment, i.e. around October 2013. The Department is already working closely with HMRC and the pensions industry on implementation and communication strategies and will use these existing fora to monitor implementation and evaluate success of the processes. This seems the least burdensome way to evaluate regulation that has been removed to avoid the instigation of any bureaucratic processes for the purpose of gathering statistics. It is understood that this would be welcomed by the pensions industry for what is, after all, a short transitional period.
Baseline: [The current (baseline) position against which the change introduced by the legislation can be measured] The baseline is the current process that has been in place since 1988. It is well understood by the industry and HMRC and there is common agreement over what that process is.
Success criteria: [Criteria showing achievement of the policy objectives as set out in the final impact assessment; criteria for modifying or replacing the policy if it does not achieve its objectives] If the new processes are operating smoothly and without major incident / cost for either HMRC or the wider pensions industry.
Monitoring information arrangements: [Provide further details of the planned/existing arrangements in place that will allow a systematic collection systematic collection of monitoring information for future policy review] The Department will use existing fora that meet regularly for exchange of information and issue resolution. This will ensure that all the same people who planned and implemented abolition will be responsible for its evaluation. There should therefore be a common understanding and consistency in approach. It is expected that evaluation is actually a standing agenda item.
Reasons for not planning a PIR: [If there is no plan to do a PIR please provide reasons here]