EXPLANATORY MEMORANDUM TO

THE STAKEHOLDER PENSION SCHEMES (AMENDMENT) REGULATIONS 2005

2005 No. 577

1. This explanatory memorandum has been prepared by the Department for Work and Pensions and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 These Regulations make a number of changes to the stakeholder pension to enable it to be part of the new suite of stakeholder savings products. Stakeholder pensions are a type of personal pension which comply with certain minimum standards set by Government.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative Background

4.1 These Regulations are made under powers in the Welfare Reform and Pensions Act 1999. They are subject to the negative resolution procedure. They amend the Stakeholder Pension Schemes Regulations 2000 (SI 2000 No. 1403).

5. Extent

5.1 These Regulations apply to Great Britain.

6. European Convention on Human Rights

6.1 Not applicable.

7. Policy background

7.1 The Government is introducing a new suite of regulated “stakeholder” savings products. The stakeholder pension will be the pension product in the new suite.

7.2 The main change made by these Regulations is that the risk profile of the member’s investments will be reduced as he or she approaches retirement. Where a member makes no choice about how his pension savings are invested, those pension savings will be moved automatically into lower-risk assets as the member approaches retirement. This process is known as “lifestyling”.

7.3 The administrative charges that members of stakeholder pension schemes pay are currently limited to 1 per cent per annum. These Regulations provide for an increase in the stakeholder pension charge cap. For new members from 6 April 2005, the charge cap is 1.5 per cent per annum, reducing to 1 per cent after 10 years of continuous membership in the scheme. The charge cap is being increased to enable providers to market stakeholder pensions more proactively to lower and moderate earners and hence to encourage more people to save for retirement.

7.4 However the charges for existing members will be held at 1 per cent per annum.

7.5 The Regulations also make a number of other changes in order to harmonise the rules of the stakeholder pension with the rules that apply to the other products in the stakeholder suite. These changes are largely technical, about the way the scheme is run, and should have little impact on members.

7.6 **Consultation** There was a public consultation on the regulations and twenty-two responses were received. Responses were mainly about technical issues in the draft regulations rather than issues of policy.

8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum.

8.2 These Regulations impose no new costs on the public sector.

9. Contact

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14 March 2005

THE STAKEHOLDER PENSION SCHEMES (AMENDMENT) REGULATIONS 2005

REGULATORY IMPACT ASSESSMENT

Introduction

1. The Stakeholder Pension Schemes (Amendment) Regulations 2005 (S.I. 2005/577) make a number of amendments to the Stakeholder Pension Schemes Regulations 2000 (SI 2000/1403) and these changes are the subject of this regulatory impact assessment (RIA).

2. A full list of the amendments is contained at Annex A.

Purpose and intended effect of the measure

(i) Objective

3. The Government is concerned that there are a significant number of people who are under-providing for retirement. Many people are deterred from saving because the market for financial products can be daunting. But there is also an issue about the extent to which it is economic for providers of financial products to engage with people on low or moderate earnings.

4. The Government's strategy is to free up the market to enable more people to save for retirement and to encourage financial providers to make the stakeholder pension more widely available. The amendments are designed to meet this objective.

(ii) Background

5. The Sandler review *Medium and Long-Term Savings in the UK* (June 2002) considered the provision of retail financial savings and investments. The review recommended the development of a suite of products that could be sold via a simplified sales process. These products are known as the "stakeholder suite of products". A number of the changes covered by this RIA have arisen out of the development of these products. Fuller details of the development of the stakeholder suite of products are at Annex B.

(iii) Risk assessment

6. People are living longer than ever before. The average number of years spent in retirement has increased significantly. In 1960, a man aged 65 could expect to live for another 12 years. Now he can expect to live for another 17 years. By 2050 it is projected that this figure will increase to around 21 years. Similar increases apply to women[1].

7. The effect of greater life expectancy is compounded by many people leaving the labour market before state pension age. At 64, a little over two-fifths of men are active in the labour force, and at 59, a little over half of women are active[2].

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[1] Government Actuary's Dept Actual and projected period expectations of life (years), based on actual mortality rates and projected calendar year mortality rates from the interim 2003-based principal population projections, available at http://www.gad.gov.uk/.Life_Tables/docs/5yrukperiod1981web.xls.
[2] Labour Force Survey, Spring 2004.

8. In the context of people living longer and being retired for longer it is a matter of concern for the Government, and for society as a whole, that many people are not saving enough for retirement. The Government estimates that there are likely to be around 3 million people who are seriously under-providing for their retirement. Under-providing means that their income in retirement is likely to be less than half that during their working life. In addition a larger group of around 5 to 10 million people may also want to consider saving more or working longer[3].

Options

9. In considering how to address these issues, the Government considered the following options:

- Option 1 - include the stakeholder pension in the "stakeholder" suite of savings products and include several new features, identified below under 1a, 1b and 1c.

- Option 2 - do nothing.

The Government is looking to ease the risks outlined above by encouraging greater take-up of stakeholder pensions. A number of features can be introduced to meet this objective, in particular, making it more efficient for companies to sell products to people on moderate incomes.

Option 1

10. The first option is to include the stakeholder pension in the suite of low-cost, simple, risk-controlled savings and investment products, as recommended by the Sandler review (see Annex B for more details). The stakeholder products would consist of:

- a deposit account
- a medium term savings product
- a modified stakeholder pension

The Child Trust Fund will also be available within the suite.

11. To complement this, the Government proposes to make it easier for consumers to be provided with advice about the suitability of financial products. To this end, the Financial Services Authority has announced the introduction of a new basic advice process to be used in the sale of stakeholder products. The basic advice process will provide a simpler, quicker and lower-cost form of financial advice for consumers. It will make it easier for consumers to have access to stakeholder products. The basic advice process will take the form of a question and answer dialogue between the adviser and the customer and the outcomes will take the form of recommendations for particular stakeholder products or warnings about, for example, the need to consider "rainy day" savings before making other long term financial commitments.

[3] *Simplicity, security and choice: Working for saving and retirement* Cmnd 5677 Dec 2002; page 30.

12. The stakeholder pension needs certain changes to make it suitable for the new suite of products:

Option 1a
13. **Lifestyling** Stakeholder pensions are tightly regulated to provide high standards of consumer protection. However in order to reduce the risk profile of the stakeholder pension, the Government decided that it should be lifestyled. "Lifestyling" means that as a person nears retirement, their pension investment is moved into lower-risk investments; this means they are less exposed to the potential volatility of the stock market immediately prior to retirement.

Option 1b
14. **Charge cap** A key feature of the stakeholder pension is the cap on charges. The Government has reviewed the level of the charge cap and has announced that from 6 April 2005, the cap will change. For the first ten years of membership, the cap will be an annual management charge of 1.5%; thereafter the cap will be an annual management charge of 1%. Existing members will not be affected by this amendment. The purpose of raising the cap is to meet providers' strategic concerns regarding the profitability of targeting lower and moderate earners. The expected outcome of this amendment is greater take-up and the encouragement of more people into saving for retirement.

15. The Government notes there is a risk that some providers may continue not to sell to people on lower or moderate earnings, even with an increased charge cap. The Government has therefore announced that there will be a further review of the charge cap in three years.

Option 1c
16. **Other changes** As far as possible, all of the products in the new stakeholder suite will have the same regulatory framework. The opportunity has been taken to review the existing stakeholder pensions regulations with a view to clarifying certain matters.

17. Stakeholder pensions are already a tightly regulated product. The key features and requirements are contained in regulations and amendments to those regulations will be necessary to achieve the policy objective.

Option 2
18. Doing nothing does not address the risks identified above. Without an increase in the stakeholder pension charge cap, it will not be sufficiently economic for providers to sell stakeholder pensions to people on lower or moderate earnings. Not introducing the basic selling process will further hinder take-up.

Business sectors
19. The business sectors most affected by these changes are:

- manufacturers and providers within the financial services sector, eg insurance companies and banks;

- distributors within the employment and financial services sector, eg companies, banks;

- advisers within the financial services sector, eg tied advisers, independent financial advisers.

Costs and Benefits

20. The changes set out in the regulations are of two kinds, mandatory and permissive (for details see Annex A). The most significant of the mandatory changes is the requirement to introduce lifestyling. The permissive changes encompass the increased charge cap.

Costs to providers

21. The Department consulted representatives of the pensions and insurance industry on the possible costs to business of these changes. Based on that information it is estimated that the total cost of introducing these changes is of the order of £13 million, with an additional £3 million of ongoing costs. However around £6 million (just under half) of the introductory costs and £1 million (around one-third) of the ongoing costs will arise from permissive changes, in particular the costs providers would incur if they decided to implement the new charge cap.

Benefits to providers

22. The objective of the change to the charge cap is to increase take-up, which will therefore benefit providers in the form of additional revenues. In year 1 this extra revenue is estimated to amount to £1m; however it is estimated to increase to £11 million by year 3. Savings arising from other changes, particularly the changes to dealing costs and the provision for electronic communications mean that the overall benefit to stakeholder pension scheme providers of these measures by year 3 would be of the order of £13 million per annum.

Cost to members

23. The Government is concerned that members of stakeholder schemes who joined before 6 April 2005 should continue to have their charges capped at 1% and the regulations contain a provision to give effect to this policy. The new charge cap will not therefore have any effect on existing members.

24. For new members of stakeholder pension schemes (that is, members who join on or after 6 April 2005), the cost of these measures arises from the increased charge cap (other measures are negligible in their effects on individual members). The effect on members' pension savings as a result of charges is usually shown as the reduction in yield[4]. The effect of the new charge cap is set out in the table. For people who save for the longer-term, the effects of the increased charge are relatively small.

[4] The reduction in yield illustrates the percentage point reduction in the gross return on a pension fund that could be caused by explicit charges and fees levied by the stakeholder pension scheme.

Period of investment	1% Charge cap	1.5% for first ten years, 1% thereafter
5 years	1.06%	1.58%
10 years	1.06%	1.58%
15 years	1.06%	1.32%
20 years	1.06%	1.21%
25 years	1.06%	1.17%

Benefits to members

25. Members and potential members of stakeholder pension schemes will benefit in two ways from these changes:

(i) Lifestyling

(ii) Membership reach

(i) Lifestyling

26. As people approach retirement the security of their pension savings is increasingly important. Lifestyling is a means of smoothing the potential variability of equity-based investments. When stock markets perform well from year to year a lifestyled fund can under perform a fund based in equities. However when stock markets experience a severe slump, a lifestyled fund can outperform a fund that retained its equity exposure.

27. The Government recognises that lifestyling may not be appropriate in all circumstances. The regulations therefore provide that the member can opt out of lifestyling if he or she wishes (possibly during the period leading up to the commencement of lifestyling).

(ii) Membership reach

28. The Government's objective that more people should save for retirement can only be met if the providers of stakeholder pensions are willing to engage with more people on lower or moderate earnings. Estimates made by the Department about the groups most at risk of under-providing for retirement show that currently it is only economic for providers to engage with around 43% of these individuals. However increasing the cap to an annual management charge of 1.5% for the first ten years of membership is designed to make stakeholder pension providers refocus their efforts on this group, and, if achieved, will thereafter increase the "reach" to encompass around 62% of the people most at risk from under providing.

(iii) Consumer choice

29. The measures should also have a positive effect on consumer choice. The increased marketing to people on lower and moderate incomes should lead to the greater availability of products and hence to greater choice.

Equity and fairness

30. The policy should help more people save for retirement, particularly people on lower incomes with whom it is currently not economic for providers to engage.

31. This policy does not have any race equality aspects and nor will it disproportionately affect any vulnerable or already disadvantaged group.

Competition assessment

32. Increasing the charge cap increases the return to providers of stakeholder pensions and it will reduce the payback period for their investments. The new basic advice sales process should also lead to a reduction in providers' costs. These factors should lead to more companies considering whether to enter the stakeholder pension market, more aggressive competition by existing stakeholder providers and hence to more competition.

Small firms' impact test

33. These changes will have very little, if any, impact on small businesses. All stakeholder pension schemes are backed by large companies such as banks, building societies and insurance companies.

Enforcement and sanctions

34. The Occupational Pensions Regulatory Authority (Opra) already has the responsibility of ensuring that stakeholder pension schemes meet the requirements set out in legislation. From 2005 the new Pensions Regulator, provided for in the Pensions Act 2004, will take over this role. In addition there are further safeguards. Each year the trustees or managers of stakeholder pension schemes have to produce a declaration that there are systems and controls in place for the purposes of compliance with the stakeholder requirements. That declaration is then audited by an independent reporting accountant. Both the declaration by the trustees or manager and the statement made by the reporting accountant have to be made available to members.

35. Inland Revenue and FSA also have responsibilities in terms of the tax approval of pension schemes and the selling and marketing of pension products respectively.

Monitoring and review

36. The Government has announced that it will review the effects of the charge cap after it has been in place for three years. Other changes made by the regulations will be kept under review.

Consultation

37. Within Government there have been consultations with Treasury and the Occupational Pensions Regulatory Authority. The Financial Services Authority has been consulted as have industry and consumer groups.

38. The Government has also undertaken a public consultation on the proposals. Amongst others, all stakeholder pension schemes were sent a copy of the consultation document. Twenty-two responses were received. As a result of comments made in the responses, a number of technical changes have been made to the regulations, including to the provisions on lifestyling. These changes should not have an impact on business costs.

Summary

39. The attached table summarises the costs and benefits of the proposals.

<table>
<tr><td colspan="2">OPTION 1 - Introduction of stakeholder products</td></tr>
<tr><td>Costs</td><td>Stakeholder pension schemes
Total cost of introducing changes will be £13m start up costs and £3m ongoing costs.
But around £6m of the start up costs and £1m of the ongoing costs will arise from permissive changes.
Members
The increased charge will lead to an increased reduction in yield.
However existing members of schemes will still have their charges capped at 1%.</td></tr>
<tr><td>Benefits</td><td>Stakeholder pension schemes
By year three the overall benefits to schemes will be around £13m per annum.
Members
The introduction of the requirement for lifestyling should reduce the volatility of investments as the member approaches retirement.
It will be more economic for stakeholder pension schemes to engage with more of the people who are at risk from undersaving.
Government
The measures will help to increase the numbers able to save for retirement.</td></tr>
<tr><td colspan="2">OPTION 2 - Do nothing</td></tr>
<tr><td colspan="2">This option would not address the issue of encouraging or facilitating the higher take-up of stakeholder pensions.
Without an increase in the charge cap it would not be economic for stakeholder pension schemes to engage with people on lower or moderate incomes.
Without the basic advice process, the extent of market penetration would be limited.</td></tr>
</table>

40. The Government's objective is to enable more people to save for retirement, particularly those on lower or moderate earnings. The increase in the charge cap, together with the new basic advice process, should enable stakeholder pension providers to make their products more widely available. The Government therefore decided to implement Option 1

41. In order to reduce the risk profile of the stakeholder pension the regulations are being amended so that where the member has made no choice about his investments, it is mandatory to provide lifestyling as the member approaches retirement. The stakeholder pension will be able to be sold via the basic advice process.

42. The opportunity has also been taken to review other stakeholder pension regulations so that, as far as possible, the products within the stakeholder suite will share a similar regulatory framework.

Ministerial Declaration

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed Malcolm Wicks

Date 9 March 2005

MALCOLM WICKS MP

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Annex A

Proposed Changes to the Stakeholder Pension Schemes Regulations

Introduction

1. The amending regulations make a number of changes to the Stakeholder Pension Schemes Regulations 2000 (SI 2000 /1403) ("the main regulations"), some mandatory, others permissive. The changes are listed below.

Mandatory Changes

(i) Lifestyling

2. Where a member makes no choice about the way his pension savings are invested, the amending regulations require that the pension is lifestyled at least five years before retirement. ("Lifestyling" means that prior to retirement the member's pension investment is moved gradually into safer investments eg cash and gilts to dampen down volatility.)

3. People who are already members of stakeholder schemes and have made no choice about how their pension savings are invested will be given the opportunity of having lifestyling applied to their pension savings.

(ii) Charge cap

4. Existing members (members who join before 6 April 2005) will continue to have their charge capped at 1%.

(iii) Court orders

5. Where a court order is made which has the effect of reducing a member's rights, the scheme must comply with that order. The scheme will be able to deduct any costs or expenses incurred in complying with that order from the member's pension rights.

(iv) "Look through

6. The policy has always been that where a fund in which a stakeholder scheme invests itself invests in another fund, the total of all management charges must not exceed the specified charge cap. The amendment is to clarify the position and there is no change in policy.

(v) Winding up

7. Some minor textual changes to the amending regulations clarify the steps trustees and managers have to take when winding up a scheme.

Permissive Changes

(i) Charge cap

8. The amending regulations provide that for new members the charge cap is to be an annual management charge of 1.5% for the first ten years of membership, and thereafter 1%.

(ii) Calculation of charge cap

9. The amending regulations also provide that, as an alternative to calculating the charge cap at member level, the cap can be calculated at fund level.

(iii) Dealing costs

10. Dealing costs are the costs incurred in buying and selling assets, a key part of managing an investment portfolio. The main regulations currently provide that most dealing costs may be ignored when calculating the charge cap but some must be counted. The amending regulations provide that all dealing costs are to be excluded from the calculation of the charge cap. This change will help to make the administration of schemes more efficient but with only a minor effect on members. The amending regulations also provide that dealing costs can be calculated at fund level.

(iv) Market value adjustments

11. The main regulations are being amended to provide that in with-profits schemes, a market value adjustment can be made outside the charge cap.

(v) Electronic communications

12. This is an amendment to extend the circumstances when schemes can use electronic systems for communications with members.

(vi) Maintenance costs of property

13. Where a pension scheme invests in property there are usually ongoing costs for example for maintenance. The amending regulations provide that where the stakeholder pension scheme invests in property, any ongoing costs such as maintenance are to be excluded.

(vii) Single pricing

14. Single pricing means that if a stakeholder pension scheme wants to invest for example in a unit trust, it can only do so if the units are single priced. This is to provide transparency and simplicity for the scheme member. The amending regulations provide that this requirement only applies to funds into which the stakeholder pension scheme directly invests and not to any indirect investments made on behalf of the scheme by others. This is because the benefits of single pricing – transparency and simplicity – are only apparent with directly held investments.

(viii) Rounding

15. Schemes need to be able to round when calculating the charge. This has always been the policy and Opra have issued guidance to this effect. This amendment permits rounding to the nearest penny.

Annex B

Stakeholder Suite of Products

Introduction

1. The Sandler review *Medium and Long-Term Savings in the UK* was published in July 2002. The review found that whilst there is much that is positive in the retail savings market there are also a number of difficulties for consumers. The market is complex and there is considerable opacity as well.

2. The review recommended the introduction of a new suite of simple, investment-restricted, low-cost investment products to be sold via a simplified advice sales process.

3. The Government accepted the recommendation and has been working with the Financial Services Authority on the introduction of these products.

Development

4. The developmental work on the new products has been taken forward in two strands, the first strand led by HM Treasury and DWP and the second by FSA.

HMT and DWP strand

February 2003 Proposals were published for consultation on the suite of stakeholder products[5].

July 2003 The results of the consultation were published in July 2003[6]. The response announced that the suite would consist of

- a short term savings product in the form of a cash deposit account (a rebranded CAT-marked cash ISA);
- medium term investment products including a unit-linked and smoothed investment option;
- a pension product (this will be the stakeholder pension).

The Child Trust Fund would also be made available within the suite.

During 2003 The Government commissioned Deloitte to undertake independent research into the charge cap[7]. The research examined trade-offs between consumers, distributors, and providers of a range of charge cap options for the medium term and pension products.

June 2004 HM Treasury consulted on draft regulations on the deposit account and medium term savings products[8].

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[5] *Proposed product specifications for Sandler "stakeholder" products* February 2003.
[6] *Government response to the consultation on Sandler "stakeholder" product specifications* July 2003.
[7] *Assessing the likely market impacts of charge caps on retail investment products* Deloitte July 2003.
[8] *Consultation on "stakeholder" savings and investment product regulations* HMT June 2004.

November 2004 HM Treasury made the Financial Services and Markets Act 2000 (Regulated Activities)(Amendment)(No.2) Order 2004 (S.I. 2004 / 2737) and the Financial Services and Markets Act 2000 (Stakeholder Products) Regulations 2004 (S.I. 2004/2738). HM Treasury also published a response to the consultation[9].

November 2004 DWP consulted on a set of draft regulations (the subject matter of this RIA).

FSA strand

January 2003 FSA published a Discussion Paper which outlined three sales process options[10].

July 2003 FSA published feedback on the three options[11] and announced they would begin market testing a "filter question" approach to the sales process.

December 2003 FSA published initial findings from this research and concluded that a second stream of research was needed in order to ensure that the process delivered an adequate degree of consumer protection.

November 2004 FSA announced that it will implement the basic advice process in support of the Government's proposed stakeholder products initiative, with effect from April 2005.

[9] These documents can be found at www.hm-treasury.gov.uk/stakeholder
[10] Discussion Paper 19 *Options for regulating the sale of "simplified investment products"* FSA February 2003.
[11] Feedback statement on DP19 *Options for regulating the sale of "simplified investment products"* FSA July 2003.