Consultation on the Portability of Supplementary Pensions Directive 2005

A response by the National Association of Pension Funds, Association of British Insurers, Confederation of British Industry, and EEF

Introduction

This submission is made on behalf of the NAPF, ABI, CBI and EEF. Together, we not only represent the views of over 6000 business organisations employing nearly 7 million of the UK workforce, but also via the NAPF, organisations providing pensions covering 10 million working people and accounting for one sixth of the investment in the UK stock market. The ABI's membership administers one-third of trust-based occupational pensions in the UK.

We welcome the opportunity to comment on the DWP consultation exercise on the draft Directive.

Executive Summary

1. We support the draft Directive's underlying principle of removing barriers to worker mobility but its final text and implementation must ensure the retention of affordable and adequate workplace pensions.
2. Portability of workplace pensions should be covered by the principle of subsidiarity and Member States must be free to determine their own detailed rules on vesting, waiting periods and the transferability of pension rights.
3. The UK already has one of the most flexible pension systems in the EU with vesting, transferability and protection for early leavers already well established. These rules have not proved to be a barrier to labour market mobility in the UK. However, the Directive creates the very real risk that these flexible rules might be "gold-plated", adding to scheme sponsors' costs and hastening the shift to defined contribution schemes. The result of this would be a general reduction in pension provision.
4. The best way to extend and strengthen supplementary pensions is to enable schemes and scheme sponsors to operate in a flexible and cost effective manner in the context of the voluntary system in the UK.
5. Implementation of this Directive by July 2008 is an unacceptably short timescale given that pension schemes are already having to cope with an unprecedented volume of legislative changes, including the consequences of the 2004 Pensions Act and the new tax regime from 6 April 2006.
6. If the effect of Article 6 is for schemes to be required to accept transfer values, this would create additional costs in the absence of any simplification of the process and would be incompatible with UK restrictions on contracting out.
7. We also believe that Article 6 should be absolutely clear that "the transfer of all acquired rights" does not require transfers from defined benefit schemes to be fully funded.

General

1. We support the draft Directive's underlying principle of removing barriers to worker mobility within the European single market but we would agree with the EFRP that that "a difficult balance needs to be achieved between providing affordable and adequate (workplace) pensions and increasing the flexibility of labour markets".[1]

2. Portability of pensions is an issue that should be clearly governed by the principle of subsidiarity which would ensure that the widely differing pension systems that exist across the EU are not disrupted. Member States should be free to determine their own detailed rules on vesting, waiting periods, indexation and the transferability of pension rights. And within this legal framework, occupational pension schemes should be free to set their own scheme rules, suitable to the workforce covered.

3. The UK already has among the most flexible pensions systems in the EU with vesting, transferability and protection for early leavers well established over the past two decades. In our experience, these rules have not proved to be a barrier to labour mobility within the UK. A Directive (even a principles-based Directive which, in our experience, would have a tendency to be "gold-plated" on transposition into domestic legislation) has the potential to place unnecessary and unacceptable costs on employers and other scheme sponsors. We are concerned that this will have the consequence of hastening the shift from defined benefit to defined contribution pension schemes which has tended to result in lower scheme contributions and smaller pensions for working people. This would not be an acceptable outcome for us or, we believe, the Commission and the UK Government.

4. In our view, the best way to maximise pension coverage – particularly to those sections of the workforce that are not currently covered by workplace pension provision – is to ensure that employers and other scheme sponsors are able to provide pension schemes in a cost-effective manner. If this Commission proposal were to go ahead as currently proposed, it would potentially impose unacceptable cost burdens on schemes. We are cautious about the potential impact of the introduction of minimum entry ages and maximum waiting periods simply because of the many pressures facing schemes at this time. An additional imposition however small may therefore have a disproportionate impact.

5. Moreover, from an employer's perspective, these measures will be viewed as intervening in private employment contracts which add to employment costs. In almost all EU-25 Member States' workplace pension schemes are established voluntarily by either employers or the social partners. Employees join these schemes either voluntarily or by way of a condition of their contract of employment. But if workplace pension provision becomes too onerous for employers, they will withdraw from such schemes or try to renegotiate the terms of the collective agreement to accommodate the cost increases. This will be at the expense of the workforce.

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[1] *European Federation for Retirement Provision, Press statement; 20 October 2005*

6. We should also distinguish between giving fair value to workers who change jobs and build up rights in supplementary pension schemes, and transferability. Transferring rights is mainly an administrative issue which although important in preventing “proliferation”, the building up of small pension “pots”, and the problems of keeping track of these over a working lifetime is not necessarily the best answer for individuals. The rules surrounding transfer are complex and in that context, a requirement for schemes to accept all transfers in the absence of any improvement to these rules would only add to costs.

7. We would also point out that Article 6 refers to the transfer of pension rights whereas UK legislation gives the right to transfer the value of those rights. Member states should be able to interpret rights to transfer in this way and it would be undesirable if the effect of the Directive were to require rights to be replicated in another scheme. In that connection, we would be extremely concerned if the right to transfer were inadvertently extended to members receiving pensions due to lack of clarity in the drafting.

8. We believe that the timescale for implementing the Directive by July 2008 is too short. Workplace pension schemes in the UK are only just coming to terms with a new regulatory regime and an entirely new set of tax rules. We will also have another major piece of primary legislation at about the same time following the Pensions Commission’s report. We suggest that the Directive be held over until 2010 and implemented at the same time as the proposed Pension Reform Act.

Specific Questions

Question 1: Do you think that the proposed Directive will better facilitate the free movement of workers within the EU?

In principle we believe that the proposed Directive will have this effect although its influence will most probably be marginal. The issue of cross border portability is probably more significant than movement within the UK, given the flexible nature of the UK pensions transfer environment.

Question 2: Have you experienced reduced mobility of workers caused by the rules of supplementary pension schemes? If so, were the problems relating to worker mobility within the UK or between the UK and another Member State?

We are not aware that the current rules cause problems within the UK. Difficulties are more probably created for cross-border employees because of the widely differing regulatory, social security and tax practices within member states.

Question 3: What schemes do you think are included in the scope of the Directive? Does the current definition capture any non-occupational pension schemes?

The definition of "supplementary pension scheme" refers to "any occupational scheme" and could include a group personal pension or stakeholder pension plan made available by an employer to its employees to provide supplementary pensions for them. However, the signatories to this paper disagree as to whether this would result in Group Personal Pensions and Employer Stakeholder Pensions being included within the scope of the Directive. The ABI believes that their inclusion would not be appropriate as the key relationship is between the individual and the insurer, not between the insurer and the employer. In addition, to include them within the scope of the Directive would complicate the regulatory landscape and add to cost of running such schemes.

Question 4: Are there any schemes you think are included in the definition of a supplementary pension schemes that should not be? Are there any schemes that are not included that you think should be?

Please see above.

Question 5: Are there occasions when employment is terminated by either party when the Directive should not apply?

It is common practice for schemes to have forfeiture provisions in the rules where the trustees can recover losses arising from fraud or theft from the pension benefits. Although it is a power that is discretionary and not often used, schemes should be able to retain this power.

Question 6: Are there any other terms that should be defined in the Directive?

It would be helpful if "occupational scheme" were defined as a sub-category of "supplementary scheme".

There is a lack of clarity in the meaning of both "acquired" and "pension rights" which should cover the rules governing vesting in supplementary schemes and which establish entitlement to a pension based upon employer and employee contributions.

Question 7: From April 2006, in UK law it will not be mandatory to return employee contributions if the employee leaves within three months of joining the scheme. What would the effect be on UK schemes if this was made mandatory?

We believe that this would have a marginal effect as it is market practice to return contributions in such circumstances in order to avoid small amounts of pension accumulating in the scheme. However Article 4 (a) is not clear as it implies that employer contributions must be returned.

We cannot believe that this is the policy intention. The return of employee contributions only is standard practice in the UK. To require employer contributions to be returned as well would add to employers' costs and create the risk of members leaving schemes to get cash refunds. This would undermine the principle of building up supplementary pensions.

Question 8: From April 2006 UK law will allow a scheme to refund the value of contributions after investment rather than total contributions if a member leaves before their pension rights vest. What would be the cost to schemes if it was mandatory to return the contributions?

Regulation 3[2] of the relevant legislation only requires interest to be paid where the scheme rules already specify. We do not anticipate that this will therefore add to costs in defined benefit schemes but in defined contribution schemes where contributions are directly invested this may add to costs if it became mandatory to return contributions. It is difficult to estimate any cost as it depends upon the number of schemes and members affected.

Question 9: What would the cost be to UK schemes if a minimum entry age of 21 was imposed for all occupational pension schemes?

Our own estimates which are based upon the Government Actuary's 2004 Survey estimates of the number of members affected, suggest an extra £32m per year for a minimum entry age. We have used a weighted average employer's contribution of 11.5%. See the Appendix for more information.

[2] The Occupational Pension Schemes (Early Leavers: Cash Transfer Sums and Contribution Refunds) Regulations 2006 SI 33

Question 10: What would be the cost to UK schemes if waiting times for all occupational schemes were limited to a maximum of one year?

Similarly to Question 9, we estimate £55m per year for a maximum waiting period. Please also see the Appendix.

This could have a negative impact on UK pension schemes Some defined benefit schemes have waiting periods of longer than one year with a stakeholder pension for the interim period in the interim. Others may have an occupational defined contribution scheme with perhaps entry to the defined benefit scheme after 5 years. The minimum period ought to apply to the first level entry to any two-tier occupational or supplementary pension scheme.

Question 11: Do you think that the article as is stands will allow UK schemes to continue to uprate deferred pensions in line with price inflation up to a limit of 5%? If not, what amendments to the text would be required?

We believe that it does although it would be helpful if the Directive made it clear that member states should make the decision about what constitutes a "fair adjustment". In this way the diverse systems can accommodate the high level requirements consistent with legal, economic and social factors. It would not be desirable for the EU to specify the meaning of "fair adjustment".

We would also hope that this provision will not apply retrospectively.

Question 12: What would the impact be on UK schemes if they were required to accept incoming transfers?

In a context where the rules governing transfers are already complex, this would create considerable difficulties without necessarily improving members' rights or benefits and would add to schemes' costs. This is especially relevant to transfers of defined benefit pension rights.

There are restrictions on transfers between contracted out and non-contracted out schemes which are incompatible with a general requirement to accept transfers.

Many schemes which are contracted out on a salary related basis have also made a pragmatic decision not to accept contracted out rights from other schemes as a way of managing and limiting their liabilities. This is a judgment about balancing the interests of other scheme members and the plan sponsor who would otherwise have to underwrite contracted out promises arising from service with another employer.

We have a concern about the phrase in Article 6: "the Member States… shall take the necessary action to ensure" when added to "the transfer … of all his acquired pension rights". This could be interpreted as requiring Member States to impose an obligation on employers to fully fund a transfer value from a defined benefit scheme. This potentially substantial increase in costs for UK employers would be unacceptable. We do not think that it is the intention but the Directive must not be ambiguous on this point.

We are not certain how the directive affects group transfers without consent where typically there is a business or a scheme restructuring.

Question 13: How long is required by a pension scheme to complete a transfer?

According to the Capita Hartshead scheme administration survey[3], specialist third party administrators allow between 10 to 40 working days depending upon the complexity and nature of the case. (For example if actuarial input is needed this will add to the time taken.) Median turnaround time was 14 working days. The comparable figure for in-house schemes was 4 to 34 days and 10 days respectively. This of course does not take into account the time taken for members to decide and sign the paperwork or for the transferring scheme to provide information; in which case the time taken might stretch to several months, say between 3 and 6 months. Schemes should not be held responsible for delays outside their control. It is worth commenting that much of the delay could be reduced if the regulatory framework were less detailed. The ABI is also leading an initiative to standardise the process.

Question 14: In what circumstances (if any) should schemes be able to reduce transfer values? What would be the impact on UK pension schemes if they could not reduce transfer values in any circumstances?

Trustees of defined benefit schemes have a duty to protect the interests of all the members and should therefore have the ability to reduce transfer values in an underfunded scheme. The Article should stipulate that the calculation of the amount of the transfer must be in accordance with national practice, be fair and reasonable to the outgoing worker, without adversely affecting the rights and interests of the remaining members of the scheme.

Question 15: What impact would there be on UK schemes if they were unable to subject incoming transfers to vesting conditions?

There would be a more significant impact on defined benefit schemes if there were no minimum vesting conditions and an undoubted cost.

Question 16: Is it appropriate to compare pension rights transferred in to a scheme to dormant rights in the same scheme?

We think so. Transfer is an administrative device and should not affect the underlying value of the benefits. In other words, members should expect to be neither better nor worse off by transferring. The form of the benefits offered for a transfer payment in the receiving scheme is a decision for the trustees who may offer a fixed pension, additional years of service or a money purchase investment. As long as there is actuarial equivalence between benefits being given up in the transferring scheme and benefits offered in the receiving scheme, according to appropriate actuarial guidelines, we think that the principles of the directive are met.

[3] The 12th Pension Scheme Administration Survey 2005, Capita Hartshead, May 2005.

Question 17: What is the normal administrative charge for a transfer and is this usually borne by the scheme or the outgoing worker?

Market practice is for transfer costs to be borne by the scheme. There is an exception for pension sharing on divorce where schemes can recover the reasonable administrative costs of implementing pension sharing orders either by setting up a pension credit within the scheme or transferring the value of that credit to another scheme.

Question 18: Will the current draft of the Directive increase the obligations of Pension Schemes to provide information?

There is a risk that it may do so. The information requirements of the Directive should be reviewed against domestic legislation to ensure that there is no overlap or unnecessary duplication.

Question 19: How long would it take schemes to make the changes necessary to implement the Directive?

Introducing this legislation into UK law might be lengthy as areas such as divorce, contracting out and the assessment period for the Pension Protection Fund would require a lot of amendment to already very complex regulations.

Question 20: Are there any circumstances in which you can conceive the UK wishing to use these exemptions?

We cannot think of any.

Question 21: Should schemes in wind-up be exempt from the Directive? What would be the impact if they are not?

We think that they should be. In those schemes, members are not accruing any pension rights. They will be transferred to an insurance policy when the process is completed. This also applies to the assessment period for the Pension Protection Fund where transfers are suspended.

Appendix: the impact of a minimum entry age and a maximum waiting period

According to the Government Actuary's Department[4], there were an estimated 380,000 members in schemes with either entry ages higher than 21 or waiting periods longer than 1 year. The box below shows in thousands the numbers covered, broken down by DB and DC coverage.

	Entry age > 21	Waiting period > 1 year	Total
DB	40	120	160
DC	100	120	220
	140	240	380

To estimate the extra cost of reducing the entry age to 21 and the waiting period to 12 months, we have assumed an increased flow of new entrants of 10% of the population covered (in other words, there are 38,000 potential members whose for scheme membership has not yet been triggered) and a take up of 80% of those entrants. We assume then an extra 30,400 new members per year more than if the conditions were unchanged.

We also assume that these employees earn the average annual salary of approximately £25,000 per year.

We have assumed an average weighted contribution of 11.5% which is based upon the average DB employer's contribution of 20% and the average DC employer's contribution of 6% of pensionable pay.

We estimate that this would cost an extra £87m in employer contributions in one year, which proportionately breaks down as £32m for minimum entry age and £55m for the maximum waiting period. In addition, there would be one-off costs associated with changes to scheme rules, booklets, administration procedures and systems.

[4] *Occupational pension schemes 2004: Twelfth survey by the Government Actuary*, GAD, 2005