

Abolition of Contracting Out on a DC Basis

The NAPF Submission to the Government's consultation

October 2010

Executive Summary

The NAPF and its members are supportive of the abolition of contracting out for defined contribution (DC) schemes. This move will help simplify the complex interaction between workplace pensions and the state pension system. But we would urge the Government to consider allowing transfers from contracted out DB schemes to any HMRC-registered or Qualifying Registered Overseas Pension Scheme (QROPS) post April 2012.

Restricting transfers of this nature would be harmful because:

- It would severely limit individuals' ability to transfer their own pension rights to suit their needs and circumstances;
- It would increase administrative cost and complexity for pension schemes; and,
- It runs contrary to the European Commission's portability agenda.

Individuals choose to transfer their pension rights out of contracted out DB schemes for many reasons:

- They may want to amalgamate their smaller pension into a single pot;
- They may have concerns about the future viability of their sponsoring employer; or,
- They may want to make use of facilities like income drawdown.

This is not to say that transferring out of a contracted out DB scheme would be in every members' best interest. Individuals must understand the risks associated with transferring out of a contracted out DB scheme and should be encouraged to seek independent financial advice before making their decision.

Introduction

1. **The National Association of Pension Funds is the leading voice of workplace pensions in the UK. We speak for 1,200 pension schemes with some 15 million members and assets of around £800 billion. NAPF members also include over 400 businesses providing essential services to the pensions industry.**
2. The NAPF and its members have been supportive of the DWP's commitment to abolish contracting out for DC schemes. This is an important step in simplifying the complex interaction between workplace pensions and the state pension system and will, in time, allow for lower cost, clearer communications and better member understanding of pensions.

3. We appreciate the need to remove references to DC contracting out in existing legislation and regulation. However, we would urge the DWP to consider the indirect consequences of removing references to transfers between contracted out DB schemes and DC schemes post April 2012. Individuals must be able to transfer their contracted out DB rights into DC schemes post-abolition if simplicity and clarity are to be achieved. Transfers of this nature are used by the industry in a wide range of situations and a ban would severely limit choice for individuals and would increase administrative cost and complexity for schemes.
4. Historically, there may have been a need to allow transfers only between contracted out schemes in order to protect the contracted out rebate. This would have been the case in 1978. In the years following, other protections emerged such as the requirement to provide a spouses' benefit and minimum indexation requirements. More recently, however, the Government has accepted that such rigid protections are no longer necessary. This is demonstrated by policy imperatives such as the switch in indexation from Retail Prices Index (RPI) to Consumer Prices Index (CPI), the abolition of safeguarded rights, and overall improvements in state pension entitlements for women.
5. A ban on transfers between contracted-out DB schemes and DC schemes would also run contrary to the principle of portability. This issue has been raised by the European Commission and features prominently in the EC Pensions Green Paper. The Green Paper focuses on "the need to facilitate the free movement of labour and capital, so as to use resources efficiently and create favourable conditions to maximise income."¹ In addition, this runs contrary to the Coalition Government's flexibility agenda, which has driven its policy to abolish the requirement to annuitise at age 75.
6. We do recognise that allowing transfers between contracted out DB schemes and DC schemes post 2011 raises issues around of survivors' benefits in the case of spouses or civil partners. Members who transfer out of a contracted out DB scheme into a DC scheme would no longer be entitled to a survivors' pension. This does not prevent members from securing survivors' benefits through their own arrangements (by purchasing a joint-life annuity, for example). In addition, the abolition of safeguarded rights in April 2009 has already acknowledged that there is little need for such rigid protection of survivors' benefits and/or spouses' pensions.

¹ European Commission Green Paper, "Towards adequate, sustainable, and safe European pension systems," 2010.

Answers to Specific Questions

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

While we understand that references to DC contracting out must be removed from existing legislation in order to complete the abolition process. However, we would urge the DWP to consider altering, as opposed to revoking, references to transfers of protected rights between contracted out DB schemes and DC schemes. Instead of revoking the regulations altogether, the DWP should redraft the regulations to allow for transfers of protected rights from contracted out DB schemes into any other HMRC-registered UK pension scheme or Qualifying Registered Overseas Pension Scheme (QROPS). Our rationale for this amendment is explained in further detail in our answer to Question 4.

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

Contracting out, especially for a mixed benefit scheme, is highly complex and therefore requires a great deal of technical expertise. Contracted-out mixed benefit schemes will generally be aware of any legislative changes affecting them and will, in many cases, be in constant conversation with HR and finance staff within the sponsoring employer. Therefore the NAPF believes these schemes will be aware that contracting-out certificates issued to them after April 2012 will be valid for only the salary related portion of their scheme.

If this is a concern to the DWP, a simple communication in the form of a leaflet or newsletter would be adequate in raising schemes' awareness of this particular issue. Communication could also be combined with other channels or issues such as the 2012 workplace pension reforms.

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

The consultation document mentions the fact that the 2004 Pensions Act already requires schemes to communicate to their members when there are any changes to their pension provision. It should be expected, however, that due to the complex nature of contracted out arrangements many scheme members may

ask their schemes and employers further questions following initial communications.

We do not anticipate that this will greatly impact the cost of communications but it will be important to provide clear guidance to employers and schemes on how to communicate with scheme members following the abolition of contracting out for DC schemes. The Government should also provide assurance to employers and trustees that they will not be subject to litigation if they provide this information.

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

While the NAPF is supportive of abolition of contracting out for DC schemes, we do not believe there is a compelling reason for restricting transfers from contracted out DB schemes only to other contracted out schemes within the UK. We believe this restriction would actually increase the administrative burden for pension schemes and pension professionals and would severely limit individuals' ability to transfer their pension rights to suit their own needs and circumstances. In any event, the restriction would only apply to transfers within the UK and could create an incentive for scheme members to transfer rights into a QROPS.

Restricting domestic transfers would be problematic for a number of specific reasons:

Cash Equivalent Transfer Values (CETV). Both DB and DC schemes are legally required to offer early leavers the option of transferring their pension entitlements, which must be transferred into another pension scheme. In 2008, only 30% of early leavers chose to retain their pension their preserved pension entitlements.² Individuals choose to transfer out of pension schemes for various reasons:

- they may want to amalgamate all their small pension pots in order to have more buying power to purchase an annuity;
- they may have concerns over the future viability of their employer. A restriction on transfers from contracted out DB schemes mean scheme members may be "trapped" in schemes which may consequently enter the Pension Protection Fund. If this were the case, scheme members would only be eligible to receive 90% of their pension benefits instead of 100% of benefits if they could transfer into a scheme of their choice;

² ONS, Occupational Pension Scheme Survey 2008.

- they may want to make use of facilities such as income drawdown, in which case pension rights would need to be transferred to a Self Invested Personal Pension (SIPP).

Stranded Guaranteed Minimum Pension (GMP) rights. A restriction on transfers from contracted out DB schemes into only other contracted out schemes would lead to “stranded” GMP rights, where members would only be able to transfer the rights above the GMP level out of the contracted out DB scheme. The DWP could consider allowing schemes to contract their GMPs back into the State Second Pension System, which would also help alleviate the “stranded” GMP issue.

This is not to say that transferring out of a contracted out DB scheme would be in every individuals' best interest. Individuals should be encouraged to seek financial advice before making their decision to transfer out of a contracted out DB scheme. In many instances, individuals may approach their employers for information. As mentioned above, the Government should provide clear guidance to employers on how to communicate with their employees about their decision to transfer out of a contracted out DB scheme.

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