4 November 2011

Catherine.cunningham@napf.co.uk
Direct: +44 (0) 20 7601 1723

Clare Yiannakou
Contracting-out regulations consultation
Department for Work and Pensions
Caxton House
Tothill Street
London SW1H 9NA

Dear Ms. Yiannakou

The Occupational Pension Schemes (Contracting-out and Modification of Schemes) (Amendment) Regulations 2012 – NAPF response

The NAPF is the voice of workplace pensions and represents 1,200 schemes with some 15 million members and assets of £800 billion. The NAPF welcomes the opportunity to respond to the DWP's consultation on the Occupations Pension Schemes (Contracting-out and Modification of Schemes) (Amendment) Regulations 2012.

NAPF recommendation

We are extremely concerned by the Government's proposal to increase the rate of revaluation for Guaranteed Minimum Pensions from 4.0% to 4.75%. This will only increase the administrative complexity and costs to schemes and will not accurately reflect the risks taken on by contracted out schemes, particularly in an environment of stagnating earnings growth. It is unnecessary to further complicate the calculation of GMPs given the Government's plans to abolish contracting out by 2016. We therefore recommend that the rate of revaluation remains at 4.0%

This consultation seeks views on two proposed changes to the rules around contracting out. Contracting out is one of the most complex aspects of pension scheme management, a fact recognised by the Pensions Commission itself. Schemes that contract out of the state system take on additional administrative and record-keeping requirements, as well as the extra cost and risk they assume when providing benefits in place of the State Second Pension and its predecessors.

Increasing the fixed rate revaluation of GMPS for early leavers

To reflect the fact that members of contracted out schemes will not receive benefits from the State Second Pension, employers and employees who contribute to contracted out schemes also pay reduced rates of National Insurance. Earlier this year, the Government confirmed that the value of the contracted out rebate will be reduced from 5.2% to 4.8% in 2012. We believe this means schemes will no longer be adequately compensated for the risk they assume in providing benefits in lieu of the State Second Pension.

We are therefore extremely concerned that the rate of fixed rate revaluation for Guaranteed Minimum Pensions (GMP) is proposed to increase to 4.75% from its current level of 4.0%. This, in combination with the reduction in the contracted out rebate, will increase costs for schemes both in terms of the administration of GMPs and in terms of the additional risk taken on by schemes.

We understand that the DWP has based its proposal to increase the rate of revaluation on a suggestion contained in the Government Actuary's Review of Certain Contracting Out Terms, which was presented to Parliament in February 2011. In his report, the Government Actuary states that:

> "at previous reviews the then Government Actuary based his proposal for the latter fixed rate on the assumed rate of growth in average earnings underlying his recommended rebate value for defined benefit members, plus 0.5%....I propose to continue to adopt this rationale."[1]

The Government Actuary went on to recommend that the rate of revaluation should be set at 4.75%. However, no explanation was given of the earnings growth assumptions underpinning this recommendation. Given the current economic environment, we do not think that 4.75% accurately reflects current assumptions about short to medium term earnings growth. The Office for Budget Responsibility stated in its March 2011 Economic Outlook that it expects "average earnings to continue to grow relatively slowly over the near term, despite elevated price inflation."[2] The OBR went on to revise its forecasts for earnings growth to 2.0% in 2011, down from its November 2010 prediction of 2.25%.

Given the fact that earnings growth has stalled, we do not think the rate of fixed rate revaluation should be increased above its current level of 4.0%. This is particularly important considering that the Government is in the process of reviewing whether contracting out should end completely as a result of proposed reforms to the State Pension system. Adding further complexity to the management of GMPs when contracting out might end by 2016 is unnecessary.

The Government Actuary's assumptions underpinning the fixed rate of revaluation also appear to be inconsistent with the assumptions used when setting the 2012-17 National Insurance Rebates. In the Review of Certain Contracting Out Terms, the Government Actuary did not include an extra margin of 0.5% when making assumptions about earnings growth. For consistency, we do not believe it should be included in the assumptions used to set the fixed rate of revaluation.

Furthermore, increasing the rate of revaluation will increase the administrative costs to schemes. The consultation document states that "the revision of the fixed rate revaluation percentage will not introduce any new administrative burdens for employers sponsoring contracted-out defined benefit occupational schemes as they are already required to revalue the GMPs of early leavers." However, we do not believe this is the case. Changing the rate of revaluation will require schemes to undergo, at the very least, a one-off change to their systems and administration manuals. Some schemes might also need to revise their actuarial factors, which could cost thousands of pounds in actuarial fees. Depending on the way schemes revalue GMPs, some

[1] The Government Actuary's Department, "Review of Certain Contracting-Out Terms," 2011.
[2] Office for Budget Responsibility, "Economic Outlook", March 2011.

schemes might have to create a new group of deferred members within their records. Creating new categories of deferred members will incur costs.

Changing the rate of revaluation for early leavers will also impact the cost of equalising GMPs. It is difficult to estimate exactly how much this may impact the cost of GMP equalisation given the uncertainty around the process of equalisation, but increasing the cost of GMPs will no doubt affect the cost of equalising them.

Modification of scheme rules

We support the Government's proposal to provide trustees with the ability to modify their scheme rules to remove protected rights requirements without going through the expensive and time-consuming process of a Section 67 exercise. We understand the rationale behind the limited modification power as a wider power of amendment might affect members' accrued rights.

As proposed, trustees would have until the end of the 3 year transitional period to make amendments to their rules. While this is welcome, we also believe some schemes would benefit from a longer timetable. Schemes are currently grappling with a great deal of change particularly around pensions tax and the introduction of automatic enrolment. With so many competing priorities, it may be difficult for some schemes to complete the amendments within the required timeframe. We therefore recommend that the limited modification be extended appropriately. Because the modification power would not allow trustees to make changes to rules governing rights which were not formerly protected rights, we do not believe members' would be adversely affected by an extension.

We would also like to point out that it is unclear whether employers using the modification power would still be required to consult under Section 259 of the Pensions Act 2004. To ensure that the modification powers achieve their intended purpose, we do not believe that Section 259 should apply in this instance to the removal of protected rights related features of future service benefits.

If you have any questions about this response please do not hesitate to contact me.

With best wishes

Catherine Cunningham

Catherine Cunningham
Policy Adviser: Pensions
0207 601 1723