

Abolition of contracting out – consultation on a statutory override for Protected Persons Regulations

The NAPF's response

March 2013

Overview

The NAPF strongly supports the introduction of a simpler flat rate foundation pension that provides a solid floor on which people can save for their retirement, knowing with more certainty and clarity that it pays for them to save. These important reforms require the ending of contracting out of the State Second Pension/SERPS and the National Insurance rebate that is available to employers providing benefits that replicate the Additional State Pension.

The NAPF has called for the Government to introduce a statutory override that allows employers to make changes to scheme benefits to recover the loss in National Insurance rebate as a result of the end of contracting out. The NAPF welcomes the Government's proposals, contained in the Draft Pensions Bill¹, to introduce such an override. **The NAPF considers it important and fair that this statutory override also applies where scheme members are covered by protected persons regulations.** This is where employees of formerly nationalised industries that were subsequently privatised had their pension benefits protected in regulations.

The Government's state pension reforms were not foreseen when the protected persons regulations were put in place and the abolition of the National Insurance rebate applied to those who are currently contracted out of Additional State Pension and their employers would affect all employees and employers in DB schemes in a similar way. It is therefore fair and appropriate for the Government to introduce legislation that allows all employers with open Defined Benefit (DB) schemes that are contracted out to recover the additional costs that will result from the 3.4% increase in National Insurance Contributions. This will avoid employers having to discriminate between different groups of employees, incurring the associated costs of implementing and communicating the different approaches to affected employees, and not being able to recoup the loss of the rebate for some of their scheme members.

The NAPF believes that there may be other industries besides rail, coal and electricity affected by the protected persons regulations, including those from the water industry.

About the NAPF

The National Association of Pension Funds (NAPF) is the leading voice of workplace pension provision in the UK. We represent some 1,300 pension schemes from all parts of the economy and 400 businesses providing essential services to the pensions industry. Ten million working people currently belong to NAPF member schemes, while around 5 million pensioners are receiving valuable retirement income from those schemes. NAPF member schemes hold assets of some £900 billion, and account for over one sixth of investment in the UK stock market. Our main objective is to ensure the security and sustainability of UK pensions.

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¹ Department for Work and Pensions, *Draft Pensions Bill* at <http://www.dwp.gov.uk/policy/pensions-reform/the-draft-pensions-bill/>, 18 January 2013

Introduction

1. The UK has one of the most complex state pension systems in the world. Currently the state pension consists of a Basic State Pension which has one set of rules and is based on National Insurance Contributions (NICs) and an Additional State Pension (the State Second Pension/SERPs) which has another set of rules. This Additional State Pension is particularly complicated as it has been changed a number of times over the years. The option to contract out of the Additional State Pension adds to this complexity. When combined with means-tested benefits and other additional age-related benefits, it is almost impossible for individuals to understand what they can expect from the state in retirement. This acts as a disincentive to save.
2. The NAPF has for some time called for a simpler flat rate foundation pension that gives a solid floor on which people can save for their retirement, knowing with more certainty and clarity that it pays for them to save. In our 2010 report *Fit For the Future: NAPF's Vision for Pensions*² we laid out our recommendations for what this pension would look like and how the transition to the new system would work.
3. The NAPF recognises that the introduction of a single-tier state pension would result in the end of contracting out of the State Second Pension/SERPS and the National Insurance rebate that is available to employers providing benefits in lieu of the Additional State Pension.
4. The NAPF welcomes the Government's decision to introduce a limited statutory override that allows employers running Defined Benefit (DB) schemes with contracted out members to make the necessary adjustments to scheme benefits, equivalent to the cost to the employer of losing the National Insurance rebate.
5. The NAPF understands that, currently, members covered by Protected Persons Regulations (that is those who are former employees of nationalised industries that have since been privatised) would be exempt from changes made through the statutory override. The NAPF welcomes the Government's consultation on this important issue. The NAPF believes that applying such a statutory override across the board is the most fair and appropriate approach. This would ensure that all contracted out members of a DB scheme can be treated the same by their employer, whether or not they are protected persons under the regulations.
6. The NAPF warns that not extending the statutory override for Protected Persons Regulations may result in employers and schemes having to absorb or pass on additional costs. This is because they would be restricted from making changes to benefits in order to make up for the loss of the National Insurance rebate for all or some of their members. Such limitations may lead to industrial concerns and disputes for employers as the changes affect some members more than others. Employers who find themselves in a

² NAPF, *Fit the Future: NAPF's Vision for Pensions at* http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/0123_Fit_for_the_future_NAPFs_Vision_for_Pension_0310.aspx. March 2010

position where they are unable to recover part or the whole loss of the National Insurance rebate may have to absorb those costs in other places or pass them on to consumers.

7. The Protected Persons Regulations were introduced against the backdrop of the current state pension system and did not foresee the proposed changes which will result in the ending of contracting out. The NAPF proposes that employers and schemes have the flexibility to ease the burden of these necessary changes where possible. This means a statutory override is introduced that applies to all employees who are currently contracted out of the State Second Pension/SERPs.

Contracting back in

8. The introduction of a single tier state pension will result in the abolition of the Additional State Pension and contracting out.
9. The NAPF's 2012 Annual Survey shows that 83% of DB schemes open to future accruals are still contracted out. Those schemes with contracted out members offer a level of benefits that replicate the benefits the Additional State Pension would provide and employers and individuals receive a rebate on their National Insurance contributions in exchange.
10. Currently employers with contracted out employees who are members of an occupational pension scheme receive a National Insurance rebate of 3.4% between the Lower Earnings Limit and the Upper Accrual Point. These employers will no longer be eligible for such a rebate and will have to pay National Insurance Contributions at the normal rate. The proposals for a single tier state pension will result in additional costs being placed on employers unless they are able to make offsetting adjustments to the structure of scheme benefits or employee contributions to make up for the loss of the National Insurance rebate.
11. Unless these costs are minimised, they may make it more likely that employers with open DB schemes will choose to close their schemes to new members. The NAPF's latest Annual Survey, carried out in autumn 2012, found that only 13% of private sector DB schemes were still open to new members, and 55% were closed to new members but open to future accrual.
12. The NAPF has called for and supports the statutory override for employers with contracted out employees included in the Government's White Paper³ on state pension reform and the Draft Pensions Bill introduced in January 2013.
13. The NAPF supports an override that is time limited and allows employers to make adjustments to scheme benefits without member and trustee consent in order to recover the cost of the additional National Insurance Contributions they will have to make once the rebate is removed. The NAPF believes that DB schemes need a minimum of 5 years to make the required adjustments within their triennial valuation cycles in order to avoid additional expenses associated with valuations conducted outside of the regular

³ Department for Work and Pensions, *The single-tier pension: a simple foundation for saving*, <http://www.dwp.gov.uk/docs/single-tier-pension.pdf>, January 2013

cycle. This is particularly important as, according to our estimates, each valuation alone can cost anywhere from £50,000 to £100,000 for small to medium-sized employers.

14. Any statutory override should also apply to circumstances where employee consent is required in scheme rules and employee contracts.
15. The statutory override should come into effect after the Bill receives Royal Assent and before the implementation of the reforms, expected to be no earlier than April 2017. This is to ensure that employers can start planning and, in many cases, consulting on adjustments to their schemes as soon as the reforms have been confirmed and in their regular valuation cycles.

Protected Persons

16. In the 1990s, employees of formerly nationalised industries which were privatised had their public sector pension benefit levels protected in regulations. These regulations are different for the three main industries affected – coal, railways (London Transport included) and electricity. In the case of coal and electricity, amendments reducing the pension benefits of members can only be made in ‘specified circumstances’. In the case of railways, amendments cannot make future pension rights less favourable than what the member had as a public sector employee.
17. The NAPF understands that these regulations stop the proposed statutory override from applying to those who have protected persons status. The Government advises that 3% of private sector DB scheme members fall into this category. This proportion will continue to decrease as more and more of these protected persons stop accruing benefits in the DB scheme as they retire or change employer.
18. If the statutory override does not apply to protected persons, one of the main concerns is that the majority of scheme members (those who do not have protected persons status) would be at a disadvantage compared to those who have the status. This would create an issue of fairness and, in applicable circumstances, would lead employers to have to absorb part or all of the cost associated with the increase in National Insurance Contributions. Employers may choose, or may be forced by labour relations concerns, to not adjust benefits or they may choose to close the scheme to new members.
19. There will also be additional administrative burdens, HR processes and communications challenges of changing pension provision so that employers can differentiate between the higher benefits for protected persons and those who are not covered by the regulations. As the DWP recognises in its consultation document, some employers may choose to pass on these additional costs to consumers and/or make adjustments in other areas of their business.
20. **The NAPF believes that the statutory override should apply to all applicable schemes and scheme members.** This would ensure fairness, consistency and clarity and keep costs down for DB schemes affected by the proposed state pension reforms.
21. The NAPF also agrees that the protected persons regulations were introduced against the backdrop of the current state pension system. As this system is proposed to change fundamentally with the introduction of

the single-tier state pension and the end of the Additional State Pension and contracting out, these regulations should be modified accordingly and such that protected persons can be treated consistently with all other contracted out members of DB schemes.

Consultation questions

22. **Do you consider it is fair and appropriate for the Department to introduce legislation to allow employers to override the PPR to change scheme benefits for members who are ‘protected persons’, thereby enabling employers to offset the cost of the additional employer National Insurance which they will face as a result of the end of defined benefit contracting out?**

Yes, the NAPF believes that it is fair and appropriate for any statutory override being introduced for the purposes of adjusting for the loss of the National Insurance rebate as a result of the end of contracting out to apply to all applicable scheme members. Government proposals should not differentiate between protected persons and non-protected persons as this is likely to increase costs and administrative burdens. It will also cause potential industrial relations issues and communication concerns for employers who are having to make changes as a direct result of Government policy.

There is also a risk that employers may be put in a position where they decide to close an existing DB scheme to new members or that they recuperate these costs from other parts of their business.

Any statutory override should apply from the date of Royal Assent and where some employers may want the flexibility to make the necessary adjustments to their schemes sooner and contract their members back in to the Additional State Pension prior to the proposed earliest implementation date of April 2017.

23. **In looking at this issue, the industries we consider where there would be impacts are coal, electricity and rail. We think there are no impacts in the atomic energy and gas sectors. Are you aware of other industries which might be affected?**

NAPF members in the water industry are affected by protected persons regulations.