EXPLANATORY MEMORANDUM TO

THE OCCUPATIONAL PENSION SCHEMES (CONTRACTING-OUT AND MODIFICATION OF SCHEMES) (AMENDMENT) REGULATIONS 2012

2012 No. 542

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. Purpose of the instrument

This instrument: increases from 4 per cent to 4.75 per cent the amount of fixed rate revaluation of guaranteed minimum pension for early leavers from 6 April 2012; makes a technical correction to recently introduced regulations relating to the contracting-out reference scheme test certificate; and, allows trustees of formerly contracted-out defined contribution occupational pension schemes to change their scheme rules as a result of the abolition of "protected rights" from 6 April 2012.

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

Part of this instrument makes a change to correct an error identified in a report of the Joint Committee on Statutory Instruments. The Joint Committee's 26th report of session 2010-11[1] reported the Occupational Pension Schemes (Contracting-out) Amendment Regulations 2011 (S.I. 2011/1294) (see paragraph 2 of the report). Those Regulations referred to occupational pension schemes when they should have referred to the trustees or managers of occupational pension schemes. The Department undertook to correct the error. The relevant part of this instrument gives effect to that undertaking. The change makes it clear that the scheme's actuary has to send notifications to the trustees or managers of the scheme.

4. Legislative Context

4.1 Existing legislation prescribes a compound rate which may be used by contracted-out defined benefit pension schemes for the revaluation of guaranteed minimum pension for early leavers. This rate is reviewed at the same time as the Government Actuary reviews the contracting-out rebate rates[2]. The last review was published in February 2011[3]. The Government Actuary's recommendation was that the fixed rate revaluation of

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[1] http://www.publications.parliament.uk/pa/jt201012/jtselect/jtstatin/176/17605.htm

[2] Chapter 2 of Part 3 of the Pension Schemes Act 1993 requires the Secretary of State to review the level of contracting-out rebate rates and the percentage reduction in National Insurance contributions at intervals of not more than five years.

[3] "Occupational and Personal Pension Schemes: Review of Certain Contracting-out Terms" http://www.gad.gov.uk/Documents/Pensions%20Policy%20&%20Regulation/Contracting%20Out/Report_to_parliament_on_the_2011_review_of_contracting-out_terms.pdf

guaranteed minimum pension where contracted-out employment ends on or after 6 April 2012 should be 4.75 per cent.

4.2 The technical correction follows a request for clarification from the Joint Committee on Statutory Instruments[4] in relation to paragraphs 4(a) and 4(b) of Schedule 3 to the Occupational Pension Schemes (Contracting-out) Regulations 1996 (S.I.1996/1172), which where inserted by the Occupational Pension Schemes (Contracting-out)Amendment Regulations 2011 (S.I.2011/1294) and came into force on 1 October 2011.

4.3 Contracting-out on a defined contribution basis ends on 6 April 2012. Following powers taken in the Pensions Acts of 2007 and 2008, the consequential legislation to achieve abolition was made in 2011[5]. This instrument allows trustees to remove references to protected rights within their scheme rules, as protected rights will no longer exist following the abolition of contracting-out on a defined contribution basis.

5. Territorial Extent and Application

This instrument applies to Great Britain.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

What is being done and why

Increase in fixed rate revaluation for guaranteed minimum pension

7.1 A guaranteed minimum pension is a pension which has been built up in a contracted-out, defined benefit, workplace pension scheme between 1978 and 1997. The pensionable age for a guaranteed minimum pension is set at 60 for a woman and 65 for a man. If a member of such a pension scheme leaves that employment before the age the guaranteed minimum pension can be taken, the scheme has a statutory duty (under section 16 of the Pension Schemes Act 1993) to revalue the amount of guaranteed minimum pension which is due to the member until the guaranteed minimum pension may be taken. Schemes may choose from more than one method, but to provide certainty for the sponsor

[4] http://www.publications.parliament.uk/pa/jt201012/jtselect/jtstatin/176/17605.htm

[5] The Pensions Act 2007 (Abolition of Contracting-out for Defined Contribution Pension Schemes)(Consequential Amendments) Regulations 2011 (S.I.2011/1245); The Pensions Act 2008 (Abolition of Protected Rights)(Consequential Amendments) Order 2011 (S.I.2011/1246); The Pensions Act 2007 (Abolition of Contracting-out for Defined Contribution Pension Schemes)(Consequential Amendments)(No2)Regulations 2011 (S.I.2011/1724); The Pensions Act 2008 (Abolition of Protected Rights)(Consequential Amendments)(No2) Order 2011 (S.I.2011/1730)

where future liabilities are concerned, a scheme can choose to use the fixed rate revaluation method[6].

7.2 Presently, where a person's pensionable service ends on or after 6 April 2007, the percentage used for revaluation purposes is 4 per cent. The Government Actuary recommended in his report of February 2011 that where pensionable service ends on or after 6 April 2012, this figure should rise to 4.75 per cent, and the Secretary of State has accepted that recommendation.

7.3 This instrument prescribes that schemes which use the fixed rate method of revaluation will have to adopt this figure for individuals who leave the sponsor's employment on or after 6 April 2012.

Technical correction

7.4 A technical correction to Schedule 3 to the Occupational Pension Schemes (Contracting-out) Regulations 1996, which was inserted by the Occupational Pension Schemes (Contracting-out) Amendment Regulations[7] from 1 October 2011, provides clarification for actuaries certifying that contracted-out salary related occupational pension schemes meet the contracting-out conditions, as explained in above in paragraph 3. As this Statutory Instrument contains a correction, it will be issued free of charge to those who have a copy of the regulations containing the error.

Modification of scheme rules

7.5 From 6 April 2012, as a result of the abolition of defined contribution contracting-out, all rules and references to "protected rights" in pensions-related legislation will either be repealed, or where appropriate, amended. In contracted-out defined contribution schemes, protected rights are either the rights to money purchase benefits under the scheme, or where the scheme rules specify the amount of an individual's pension fund derived from the National Insurance rebate, its investment return, and any tax relief on the rebate. On abolition, protected rights will cease to exist; they will become ordinary money purchase scheme benefits.

7.6 Following a previous public consultation in 2010 on the draft consequential legislation[8] for the abolition of defined contribution contracting-out, a number of respondents were concerned that in some cases, occupational pension scheme rules relating to protected rights will not automatically fall away on 6 April 2012. This is because some occupational pension schemes rules are written in such a way as to build in

[6] Fixed rate revaluation is a method by which contracted out defined benefit pension schemes may use to revalue the amount due until the guaranteed minimum pension is taken, and uses the prescribed rates set out in Regulation 62(2) of the Occupational Pension Schemes (Contracting-out) Regulations 1996 (S.I.1996/1172)

[7] S.I. 2011/1294

[8] "Abolition of contracting out on a defined contribution basis: consultation on draft consequential legislation" 28 July to 19 October 2010 http://www.dwp.gov.uk/docs/abolition-contracting-out-dc-consultation.pdf

the legislative protected rights requirements, rather than make reference to the relevant provisions in pensions legislation.

7.7 Until the protected rights rules are removed from the scheme rules, pension providers may not be able to take advantage of the easements introduced by abolition. In some cases, schemes do not have powers to change their scheme rules. Schemes sought help to extend the benefits of abolition of defined contribution contracting-out to all their members in requesting a power to modify their scheme rules. In the response to the consultation on the draft consequential legislation[9], the Government said it would consider the issue further.

7.8 Following that consideration, this instrument provides trustees with the ability to modify their scheme rules in order to remove protected rights requirements which apply to accrued rights. The instrument also prescribes the removal of scheme rules relating to protected rights which are no longer required as a result of the legislation providing for the abolition of protected rights and the abolition of contracting-out on a defined contribution basis coming into force on 6 April 2012. The power provided is time limited; trustees will have until 5 April 2018 to make amendments to their rules.

Consolidation

7.9 Consolidation of the regulations included within this instrument will be included in due course in the Department's "The law relating to Social Security" (the Blue Volumes), which are available at no cost to the public on the internet at - http://www.dwp.gov.uk/advisers/docs/lawvols/bluevol/

8. Consultation outcome

8.1 A public consultation[10] on these draft regulations (15 August to 6 November 2011) asked for views on the proposed fixed rate percentage rate - 4.75 per cent - to be used from 6 April 2012 for revaluation of guaranteed minimum pensions for early leavers; and whether the power to modify scheme rules would enable trustees to alter their scheme rules to remove the requirements of the protected rights legislation in order to extend the benefits of the abolition of defined contribution contracting-out to their members. Views were not invited on the technical amendment.

8.2 There were 18 responses to the consultation, which included one member of the public. The eight organisations which responded to the change in the fixed rate for revaluation of guaranteed minimum pensions provided a wide range of opinion, from agreement with the proposal, to arguing for retention of the current rate or reduction in the proposed rate. As a result of these views, the Government Actuary's Department was asked to reconsider the advice given in the report of February 2011 which recommended

[9] http://www.dwp.gov.uk/docs/abolition-contracting-out-dc-response.pdf published 30 November 2010
[10] http://www.dwp.gov.uk/docs/occ-pen-contracting-out-and-modification-regs-consultation.pdf

the fixed rate for revaluation purposes should rise to 4.75 per cent. The Government Actuary's Department concluded that although there was a shift in some components of the underlying assumptions, these broadly cancelled each other out, with no change to the proposed rate of 4.75 per cent. The Secretary of State has agreed with that recommendation.

8.3 Turning to the regulations to allow trustees to amend their scheme rules to remove references to the term "protected rights" following abolition of contracting-out on a defined contribution basis, four respondents considered that the powers in the draft regulations, would meet the intention; seven organisations called for a wider statutory override power, that is, one which could have the effect of automatically removing protected rights rules from scheme rules. However, a wider power would not be possible without an Act of Parliament, which could not be achieved before 6 April 2012.

8.4 There were concerns that the three-year period - up to April 2015 - would not be long enough for schemes to make the necessary changes. To address this, the deadline has been extended to 5 April 2018.

8.5 Some respondents asked what would happen if the changes were not made within the deadline; the Government believe that the extension of the timescale will be sufficient for schemes to use this power. Government policy is that where possible, regulation should be time bound, rather than open-ended.

8.6 Concerns were raised about the interaction of some existing legislation and the new regulations, in particular, where all contributions deriving from the rebate must be applied to provide money purchase benefits; and the provisions of the "listed changes" consultations employers must undertake when making changes to pension scheme rules. Changes have been made in the regulations to clarify the first point; the second point has been addressed in the consultation response.

8.7 In addition, questions were posed about the position of short service refund lump sums. These are matters involving tax legislation, and they have been referred to Her Majesty's Revenue and Customs. If changes are deemed necessary, these will be taken forward at the appropriate time.

8.8 Some respondents raised the question of underpins. These regulations allow the term "protected rights" to be removed from the scheme's rules in relation to certain money purchase benefits and the removal of any particular protected rights rules which relate to how the scheme operates. However, the money purchase benefits will remain in the scheme, including money purchase underpins, which were formerly protected rights underpins.

8.9 The Government's response to the consultation is published at http://www.dwp.gov.uk/consultations/2011/

9. Guidance

No additional guidance is necessary. The increase in fixed rate revaluation for guaranteed minimum pension is prescribed in regulations, as is the power to modify scheme rules.

10. Impact

10.1 The change in percentage amount for the fixed rate revaluation of guaranteed minimum pension is undertaken usually once every five years, and is an event that pension schemes which use the fixed rate method will be expecting to administer. The change does not impose any new burdens on contracted-out pension schemes. The technical correction provides a clarification, so is beneficial. The modification power allows more schemes to take advantage of the benefits resulting from the abolition of contracting-out on a defined contribution basis.

10.2 The impact on the public sector is negligible.

10.3 An assessment of the impact of these regulations was included in the impact assessment published in May 2011[11] to accompany the regulations which abolish contracting-out on a defined contribution basis. It took into consideration the benefits to all schemes which could potentially benefit from the ending of contracting-out on a defined contribution basis; the figures remain up to date. A copy of that impact assessment is attached to this memorandum and will be published alongside it on www.legislation.gov.uk.

11. Regulating small business

The legislation applies to small businesses so that they are also able to take advantage of the benefits, although few small and medium employers use contracting-out on a defined contribution basis.

12. Monitoring & review

This instrument will not be reviewed or monitored as it provides end dates to the relevant amendments, and fulfils statutory requirements.

13. Contact

Richard Jordan at the Department for Work and Pensions Tel: 020 7449 7379 or email: richard.jordan1@dwp.gsi.gov.uk can answer any queries regarding the instrument.

[11] http://www.dwp.gov.uk/docs/ia-abolition-contracting-out-dc-schemes.pdf