EXPLANATORY MEMORANDUM TO

THE OCCUPATIONAL PENSION SCHEMES (EARLY LEAVERS: CASH TRANSFER SUMS AND CONTRIBUTION REFUNDS) REGULATIONS 2006

2006 No. 33

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. Description

2.1 These regulations provide a new option for certain people who leave an occupational pension scheme before normal pension age.

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

3.1 None.

4. Legislative Background

4.1 The Pensions Act 2004 introduces a new Chapter into the Pension Schemes Act 1993. This provides new statutory rights for those early leavers from occupational pension schemes who at present have no statutory rights but normally will only get a refund of their contributions in accordance with scheme rules. Provided that their service is of at least three months' duration they will be offered the choice of either a cash transfer sum that can be transferred to another occupational pension scheme or a personal pension, or a contribution refund. There are powers to set out in regulations more details about the calculation of cash transfer sums and contribution refunds and other matters. It is intended that the new Chapter and these regulations will come into force on 6 April 2006.

5. Extent

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

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

7. Policy background

7.1 Many occupational pension schemes impose a period of service in the scheme which is known as the vesting period. The maximum vesting period is

two years. Where a member leaves a scheme before the end of the vesting period he or she will not have vested rights retained in the scheme. This means that they will not have any future entitlement to any pension or benefits from the scheme.

7.2 A member who leaves before their rights have vested will normally get a refund of their contributions to the scheme. This means that such people find it more difficult to build up pension rights. This is particularly the case where a person moves from job to job frequently.

7.3 The Government therefore decided to give most members who leave their pension scheme before rights have vested an opportunity to build up pension rights. As an alternative to having a contribution refund, these members can decide instead to have a cash transfer sum that will be transferred to another pension scheme. Choosing the cash transfer sum will mean that members will be able to benefit not only from their own contributions to the scheme but also those from the employer. The Government accepted that very small amounts might cause disproportionate administration costs, and so decided that a member has to have been in a scheme for at least three months in order to qualify for a cash transfer sum. The policy represents a reasonable balance for both schemes and members and fully supports the promotion of informed choice in pension saving.

7.4 The regulations have been the subject of a public consultation and there were 21 responses. The main areas of comment were:

7.4.1 Many respondents were concerned that the regulations did not allow schemes to calculate contribution refunds in the same way they do now. This issue has been addressed in the regulations by allowing the contribution refund to take account of investment returns and interest (see regulation 3);

7.4.2 The majority of respondents were of the opinion that that Minimum Funding Requirement underpin that was proposed for the calculation of cash transfer sums on a transitional basis was not required, and that it was safe to make reductions based on the latest actuarial report. The Government has accepted the majority view;

7.4.3 The regulations should allow for administration costs to be deducted from cash transfer sums (there is a power in primary legislation for this). However the Government does not think it necessary as the calculation of cash transfer sums will, as for the calculation of cash equivalent transfer values, be done in accordance with actuarial guidance, which allows for such costs to be taken into account.

8. Impact

8.1 An assessment of the impact on business, charities or the voluntary sector of the provisions in these Regulations was included in the Regulatory Impact Assessment that accompanied the Pensions Act 2004. The relevant extract is attached.

8.2 The estimated funding costs are around £50m a year and administration costs are around £5m a year. The costs fall across all types of scheme in both the private and public sector, with roughly half the costs falling to the public sector.

9. Contact

Andy Carter at the Department for Work and Pensions Tel: 020 7962 8969 or e-mail: andy.carter@dwp.gsi.gov.uk can answer any queries regarding the instrument.

EXTRACT FROM REGULATORY IMPACT ASSESSMENT FOR PENSIONS ACT 2004

3.8 Transfer values for early leavers

3.8.1 A person who leaves an occupational pension scheme within two years of joining often does not accrue any rights in the scheme but instead receives a refund of the employee contributions less tax. The period for which a person must be a member of a scheme for their rights to be retained in the scheme when they leave is referred to as a vesting period.

3.8.2 Under the current rules a person who works for different employers for short spells, or for the same employer from time to time, may not accrue any rights to an occupational pension.

3.8.3 The Green Paper proposed that a two-year vesting period would no longer be permitted and rights would vest from the time the member joined. To avoid this resulting in schemes having to preserve small amounts of pension rights it was also proposed that trustees should be able to transfer de minimis amounts to a stakeholder pension on the member's behalf unless the member objected.

3.8.4 A number of issues were raised in consultation:

• Some respondents who supported immediate vesting did not support the de minimis transfers part of the package.
• There was concern that trustees would require indemnity against future allegations of misselling unless transfers were made only with consent.
• On the other hand, some respondents thought that transfers should be made much easier and that members should not have the option to object.
• There was concern that stakeholder providers would not be willing to accept small amounts on members' behalf.
• And there was concern that the proposals would impose excessive funding and administration costs such that employers would introduce or extend waiting periods.

3.8.5 These concerns were considered very carefully. It is still believed that opportunities should be provided for employees to build up pension savings during the current vesting period. But the original proposals have been amended. The vesting rules will not be changed. However, employees who have been members for at least three months, and who leave pensionable service before their rights in the scheme have vested, must be offered the choice of:

• a refund of their contributions (net of tax); or
• a cash transfer sum of the rights they would have accrued but for the vesting rule.

3.8.6 Members who opt for the cash transfer sum must agree to a transfer to another occupational scheme or a stakeholder pension scheme of their choice. Thus those schemes that currently operate a vesting period will not be required to preserve any extra small amounts of rights. But, importantly, members will have opportunity to kick-start their pension saving. This revised proposal fully supports the promotion of

informed choice in pension saving. Cash transfer sums can be significantly greater than refunds of contributions depending on the factors on which the calculation is based.

3.8.7 The following examples illustrate how attractive a cash transfer might be for a person who leaves a contracted-out defined benefit scheme after 18 months pensionable service having paid contributions at 6%.

Example 1 - a woman, aged 29, pensionable earnings of £20,000
Refund - £1056 (net of cost of buying contracted out rights back into state scheme and tax)
Cash transfer sum - £2,410

Example 2 - a man, aged 42, pensionable earnings of £15,000
Refund - £792 (net of cost of buying contracted out rights back into state scheme and tax)
Cash transfer sum - £2,595

Example 3 - a woman, aged 52, pensionable earnings of £15,000
Refund - £792 (net of cost of buying contracted out rights back into state scheme and tax)
Cash transfer sum £3,716

3.8.8 Cash transfer sums from defined contribution schemes will not generally vary with age and would be an attractive option for all members given a significant employer contribution and positive investment return. For example, in the case of an employee who is a member of a DC scheme (not contracted-out) for 18 months contributing 3% of earnings of £20,000 and an employer contribution of 4.5%, a refund would be £900 but a cash transfer sum might be £2,385. This would be a significant boost to personal saving for retirement which could be built on with future contributions if invested in a stakeholder scheme.

3.8.9 These proposals would particularly benefit workers who change jobs frequently. The overall impact on individuals would depend on factors such as:

• their financial awareness; or
• whether or not the employer provides a pension scheme; or
• the degree to which frequent job changers join company pension schemes in the first place; or
• the different options currently given to early leavers by different pension schemes; or
• the characteristics of those early leavers who take a contributions refund with them; and
• the degree to which any contributions refunds are currently re-invested in another pension scheme.

3.8.10 Using the examples earlier, the total cost to the defined benefit scheme of paying the refund net of tax, plus tax, plus a contracted-out premium to buy the member back into the State Second Pension for the period would be:

Example 1 - £2,850
Example 2 - £2,138
Example 3 - £2,138

3.8.11 From this can be seen that the cash transfer sum is not always more expensive than the total cost of a refund. Nevertheless the cash transfer sum would be attractive for some people, especially older people in DB schemes. Assuming a take-up rate of 20% from DB and 50% from DC schemes, it is estimated that funding costs would be around £50m a year for all occupational schemes.

3.8.12 This proposal will also result in additional administration costs. Providing a cash transfer quote in itself is not expensive – in the range £1 to £25 depending largely on the size of the scheme. But the cost of arranging the transfer could be as much as around £180. It is estimated that this proposal could result in additional administrative costs of around £5m a year with a greater impact on companies offering a defined benefit scheme where there is a high turnover of staff who join the scheme.