EXPLANATORY MEMORANDUM TO THE PERSONAL AND OCCUPATIONAL PENSION SCHEMES (INDEXATION AND DISCLOSURE OF INFORMATION) (MISCELLANEOUS AMENDMENTS) REGULATIONS 2005

2005 No. 704

1. 1.1 This Explanatory Memorandum has been prepared by the Department of Work and Pensions and is laid before Parliament by Command of Her Majesty.

1.2 This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Description

2.1 These regulations:

- remove the requirement to index pensions derived from protected rights (contracted-out rights held in a money purchase scheme) accrued pre 6 April 1997. Indexation is the annual increase of a pension in payment. The change affects pensions coming into payment on or after 6 April 2005;
- ensure that the new policy on indexation is reflected in the treatment of: hybrid pension schemes (which offer both money purchase and salary related benefits); transfers between pension schemes; and pension credits (held as a result of a pension share);
- introduce a new disclosure of information requirement for occupational pension schemes;
- as a consequence of the indexation changes, simplify the arrangements for calculating the amount of income that can be withdrawn from a personal pension fund in advance of annuity purchase;
- in relation to the new Regulatory Authority, remove the restriction on civil penalties, and make two minor drafting amendments.

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

3.1 Regulation 18 imposes a new requirement on trustees of occupational schemes to give members information regarding choice of different types of annuities and as to some of the different types of annuity available. The regulation allows schemes to rely on information contained in a leaflet to be prepared by the Pensions Regulator and approved by the Secretary of State.

3.2 The regulation is made under the power in section 113(3A) of the Pensions Schemes Act 1993. This allows the information provided by schemes to be determined by reference to guidance prepared by a prescribed body and approved by the Secretary of State. Section 113(3A) was inserted by section 52 of the Child Support, Pensions and Social Security Act 2000.

4. Legislative Background

4.1 Sections 51 and 162 of the Pensions Act 1995 (as amended by the Pensions Act 2004) contain the main provisions for indexation as applied to pension rights accrued post 1997. These regulations (which affect rights accrued pre 1997) complete the picture for the indexation of money purchase benefits – ensuring it can be removed completely.

4.2 New regulation 2 (which clarifies that money purchase benefits provided under a hybrid scheme need not be indexed) is made under the power in section 125(2) of the Pensions Act 1995. This power allows regulations to modify the application of section 51 of the Pensions Act 1995 in relation to hybrid schemes.

4.3 Regulation 18 is made under the power in section 113(3A) of the Pensions Schemes Act 1993 – an explanation of this is at paragraph 3 of this note.

4.4 All regulations, with the exception of regulation 2, are amending regulations and are within the scope of existing powers.

5. Extent

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

6.1 Not applicable.

7. Policy background

Summary of Policy

7.1 Existing indexation rules for pensions in payment are:

- for rights accrued post 1997 – all rights in an occupational pension scheme and the protected rights in a personal pension scheme must be indexed by at least the annual percentage increase in Retail Prices Index (RPI) capped at 5% (known as LPI – Limited Price Indexation); and

- for rights accrued 1988-1997 – all contracted out rights in occupational and personal pension schemes must be indexed by at least the annual percentage increase in RPI capped at 3%.

7.2 The Government's original proposal (included in the Pensions Bill 2004) was to reduce the LPI cap from 5% to 2.5% for all pension rights that attracted indexation. However, during the passage of the Bill through Parliament the

Government acknowledged that there were different arguments and legitimate concerns about the implications for money purchase benefits. In contrast with salary related schemes (where the cost of indexation falls on the scheme) the cost of indexation in money purchase schemes falls on the member, by way of a lower starting pension. Indexation does not affect the size of the "pension pot" so individuals in a money purchase scheme would not lose out from the removal of the indexation requirement. The Government's decision to remove indexation from money purchase benefits was reflected in amendments brought forward at the Lords Report stage of the Pensions Bill. This policy extends to the treatment of money purchase benefits paid from hybrid schemes.

7.3 The rules on the indexation of rights transferred between pension schemes have been relaxed in line with the main change. Where a transfer is made after 6 April 2005 indexation will only be required on certain rights transferred to salary related schemes.

7.4 The removal of the requirement to index pensions derived from money purchase benefits will mean that people affected will be able to choose between level and indexed annuities. The Government wishes to ensure that schemes provide information about different types of annuities to help individuals make this choice. These regulations cover occupational pension schemes and the required information will be included in a leaflet prepared by the Pensions Regulator which schemes can use, if they choose, to fulfil the new requirement. A similar information requirement for personal/stakeholder pension schemes is being introduced by the Financial Services Authority (and the FSA leaflet already in use will be amended accordingly) .

7.5 The rules for calculating the amount of income that can be withdrawn from a personal pension fund in advance of annuity purchase are set out in legislation. They presently require the use of tables prepared by the Government Actuary – one set of tables for protected rights and one set for non-protected rights. These regulations simplify this by removing the need for separate protected rights tables. From April 2005 all rights held in an Appropriate Personal Pension will, for interim arrangement purposes, be treated in the same way. This is in line with flexibilities to be introduced by the Inland Revenue from April 2006.

7.6 The restrictions on the maximum civil penalties are being removed to reflect the new powers of the Pensions Regulator.

Consultation

7.7 An eight week consultation exercise was conducted seeking comments on the draft regulations. Eighteen responses were received. Three topics attracted the most comment: the way the indexation changes affect hybrid schemes; how transferred benefits should be indexed and various aspects of the information requirement. Amendments were made to the regulations as a result, although the overall policy intention has remained unchanged. The comments received are discussed in the Government's response to the consultation which is available at http://www.dwp.gov.uk/consultations/2005/index.asp

8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum.

8.2 There are no public sector costs.

9. Contact

Jane Bonner-Morgan at the Department for Work and Pensions Tel: 020 7962 8411 or e-mail: jane.bonner-morgan@dwp.gsi.gov.uk can answer any queries regarding the instrument.

16 March 2005

REGULATORY IMPACT ASSESSMENT

The Personal and Occupational Pension Schemes (Indexation and Disclosure of Information)(Miscellaneous Amendments) Regulations 2005

Introduction

1. This Regulatory Impact Assessment (RIA) considers the impact of the indexation and information requirement policy changes. The main amendments are to the Personal and Occupational Pension Schemes (Protected Rights) Regulations 1996 (SI 1996/1537), The Occupational Pension Schemes (Indexation) Regulations 1996 (SI 1996/1679), Schedule 2 to the Occupational Pension Schemes (Disclosure of Information) Regulations 1996 (SI 1996/1655).

Purpose and intended effect of the amendments

Background

2. Indexation applies to pensions in payment in schemes which are tax approved. The rules on what level of indexation should be provided and which benefits should be indexed have been amended a number of times since their introduction in 1988. Rights accrued on or after 6 April 1997 are subject to Limited Price Indexation (LPI). LPI was introduced to provide protection against inflation for those people whose schemes did not increase pensions annually on a voluntary basis. The LPI provisions require that rights built up after 6 April 1997 (all rights in an occupational scheme and protected rights in a personal pension) must be increased by the annual percentage increase in the Retail Prices Index (RPI) capped at 5 per cent.

3. The Pickering Report[1] first highlighted that since its introduction in 1997 the requirement to provide LPI on pensions in payment had become disproportionately expensive. However, the Government has always been minded to retain some degree of mandatory indexation to give a good degree of protection against inflation. The Government decided to reduce the LPI cap to 2.5% for Defined Benefit (DB) schemes taking into account the burden on scheme funding flowing from the current 5% limit and to offset the increased cost imposed on pension schemes by the proposed levy for the Pension Protection Fund. Provisions in the Pensions Act 2004 achieve this intention.

4. Unlike DB schemes where indexation of pensions in payment is factored into the funding of the scheme, individuals in Defined Contribution (DC) schemes pay for indexation on retirement, by way of a reduced starting pension, when purchasing an index-linked annuity. The Government therefore decided to introduce amendments to the Pensions Act 2004 removing the requirement to provide indexation on pensions derived from DC benefits.

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[1] Alan Pickering (July 2002) 'A simpler way to better pensions – An independent report by Alan Pickering' pp13-14

5. The indexation of rights accrued on or after 6 April 1997 is provided for in primary legislation and the Pensions Act 2004 makes the necessary amendments to remove the requirement to provide indexation on these rights. Amendments to secondary legislation are necessary to remove indexation on protected rights accrued pre 6 April 1997.

Objective

6. The Government is concerned that the requirement and cost of providing LPI in DC schemes falls to the member and serves to reduce the flexibility available to that member at the point of annuitisation. Having to track various pots of accrued rights, accrued over different periods, in order to apply differing indexation regimes also adds to the administrative burden on occupational DC schemes and pension providers. The Government would therefore like to simplify these arrangements.

7. The Government's strategy is to provide members of DC pension schemes with greater flexibility and choice at the point of annuitisation. As a consequence of this it is essential to provide the information members need to help them decide what shape of annuity, either index-linked or flat rate, best suits their needs.

Risk assessment

8. The requirement to provide mandatory increases to pensions in payment was introduced originally in 1988, solely for protected rights, and was subsequently extended in 1997. This change imposed a different level of increase for accruals on or after a specific date. The Government acknowledges that this adds to the complexity and administrative burden on employers sponsoring occupational DC schemes and pension providers who are forced to track the different pots in order to apply the different indexation requirements at the point of annuitisation.

The table below illustrates the different indexation requirements for a defined contribution pension pot under the current rules.

	Part of pot	Requirements for occupational DC	Requirements for personal pensions
"Pot A"	Pre-1997 protected rights	Unisex, RPI @ 3%, 50% survivors' benefit (if married)	Unisex, RPI @ 3%, 50% survivors' benefit (if married)
"Pot B"	Post-1997 protected rights	Unisex, LPI @ 5%, 50% survivors' benefit (if married)	Unisex, LPI @ 5%, 50% survivors' benefit (if married)
"Pot C"	Post-1997 non-protected rights	LPI @ 5%	No indexation requirements
"Pot D"	Pre-1997 non-protected rights	None	None

9. As the requirement to provide indexation on pensions in payment is mandatory, when the benefits are annuitised the scheme member is forced to purchase an index-linked annuity. The Government is concerned that this limits the flexibility and options available to the member at retirement and the member may not be free to make decisions about the 'shape' of their pension income that best suits their needs.

10. Research[2] has also shown that where the member chooses an index-linked annuity their life span has to significantly exceed average life expectancy in order for an indexed annuity to provide a higher level of income than a level annuity. This has led to the calculation of various 'cross-over ages' for the point at which the total income from an index-linked annuity exceeds that from a level annuity. The Association of British Insurers (ABI) estimate that the cross over point for a 65 year old male annuitant is around 93 years of age, whilst more extreme examples calculate that the cross over age is around 114 years of age. The Government estimates that the cross-over age is somewhat lower, around 82 for a 65 year old male, but estimates are sensitive to the assumptions used.

Options

11. In considering how to address these problems the Government explored 3 options. It has now been decided to proceed on the basis of Option 2, however all three options are set out here for completeness:

- Option 1 – remove the requirement to provide mandatory indexation in DC schemes for rights accrued on or after 6 April 1997;
- Option 2 – remove completely, from DC schemes, the mandatory requirement to provide indexation on pensions in payment; or
- Option 3 – do nothing.

Option 1

[2] Association of British Insurers (ABI) (February 2004) 'Action Plan on Defined Contribution Pensions: Simplicity, Value for Money and Consumer Choice', p8,

12. One option to address the problems set out above was to remove the requirement to provide mandatory indexation on pensions derived from money purchase benefits accrued on or after 6 April 1997 in DC schemes. This option would apply to accruals in DC occupational schemes and to protected rights in appropriate personal pensions. Provisions in the Pensions Act 2004 cater for this.

13. This would mean that at the point of annuitisation the individual would only have to provide for increases capped at 3% on protected rights accrued before 6 April 1997 and would be free to choose the type of annuity that best suits their needs with rights accrued on or after 6 April 1997, one of the main choices being between a level annuity and one that is indexed and increases over time.

14. Under this option the member would have a greater degree of choice and flexibility to decide how to structure their retirement income derived from post 6 April 1997 benefits. With increased choices available it will be important that the member is well informed about the implications of each of the available options. To mitigate this risk the Government is therefore proposing that as part of Option 1, occupational DC schemes and pension providers should be required to provide certain information to inform the member and help them make a decision between the choices available.

15. The proposed information requirement would ensure that members receive factual information about annuities, including level and indexed annuities. This should highlight the considerations to be taken into account when deciding which pattern of income is most suitable.

Costs to providers

16. Removing the requirement to provide mandatory indexation on pensions derived from money-purchase benefits accrued on or after 6 April 1997 would partly ease the administrative burden and resultant costs for occupational DC schemes and pension providers. However, schemes and providers would continue to have to track separate tranches of accrued rights and could incur additional costs as they reconfigure IT systems to take account of the change.

17. This option would not impose any additional cost or administrative burden on personal pension providers as they are already required by the FSA to provide scheme members with information about the choices available. Providers can use an FSA factsheet to fulfil this requirement if they wish. Requiring occupational DC schemes to provide members with information about the choices available to them at retirement would impose additional costs and administrative burden. However, we expect these costs to be small as the requirement essentially formalises arrangements which are already in place. The costs would be similar to those imposed under Option 2 and detailed in paragraphs 24-27 below.

Costs to members

18. We do not foresee that this option would result in additional costs to scheme members.

Benefits to providers

19. Removing the requirement to provide mandatory indexation on benefits accrued on or after 6 April 1997 would result in a small saving for schemes, although this would be less than the saving identified in paragraphs 29-30 under Option 2 below. However any saving is likely to be offset by the costs to schemes of systems reconfiguration and the additional small cost of sending out information to scheme members.

Benefits to members

20. The main benefit to pension scheme members of removing the requirement to provide indexation on post 6 April 1997 rights would be a greater degree of choice and flexibility to decide whether to purchase a level or index-linked annuity. The information provided to them should enable the member to make an informed choice about what shape of annuity best suits their needs. If the member opted for a level annuity for benefits accrued after 6 April 1997 it may result in an increase in the headline pension payable from the annuity, resulting from the reduced cost of only having to provide for increases up to 3% on protected rights accrued before 6 April 1997.

Option 2

21. Rather than removing the indexation requirement solely for benefits accrued post 6 April 1997 another option considered was to completely remove the requirement in DC schemes to provide indexation on pensions derived from money purchase benefits. This would apply to protected rights accrued pre 6 April 1997, and all rights accrued after 6 April 1997. This would mean that, at the point of annuitisation, the individual would be free to choose the type of annuity that best suits their needs, one of the main choices being between a level annuity and one that is indexed and increases over time. To achieve this, amendments would be required to secondary legislation in addition to those contained in the Pensions Act 2004.

22. Removing the mandatory requirement to purchase an index-linked annuity for pensions derived from money purchase benefits will provide the scheme member with a greater degree of choice and flexibility. With increased choices available it will be important that the member is well informed about the implications of each of the available options. To mitigate this risk the Government is therefore proposing that, as part of Option 2, occupational DC schemes and pension providers should be required to provide certain information to inform the member and help them make a decision between the choices available.

23. The proposed information requirement would ensure that members receive factual information about different types of annuities including level and indexed annuities. This should highlight the considerations to be taken into account when deciding which pattern of income is most suitable.

Costs to providers

24. The introduction of the information requirement would, it is estimated, result in a small cost to schemes and providers. They will be required to send this information out to any individual whose money purchase benefits are about to be

exchanged for a pension or annuity. We estimate that this requirement will affect those coming up to retirement, around 10,000 annually in DC occupational and personal pension schemes, a figure which is likely to increase with the introduction of the 'open-market option'[3] for all schemes from 6 April 2006.

25. Schemes and providers are already required by DWP disclosure of information regulations to send out general information about the "options" available to individuals who are about to purchase an annuity, within specific time periods. The new requirement will compel occupational DC schemes to send out specific information about different types of annuities to scheme members. Under this option the Government is working to ensure that it is straightforward for trustees to provide guidance and information which clearly sets out the choices available to the members.

26. The new requirement essentially formalises arrangements that it is believed, in most cases, are already in place. It is however recognised that the change will impose small costs on schemes.

27. A similar requirement will apply to personal/stakeholder pension schemes. In addition to the existing disclosure of information regulations, FSA rules already require that personal pension schemes send information about the open market option and annuities when an individual is approaching annuity purchase. Under Option 2 the FSA would make amendments to their Conduct of Business Rules that have a similar effect to the DWP proposals for DC occupational schemes. Providers would still be able to use the relevant FSA leaflet to fulfil this requirement, or would need to check their own literature to ensure it included the relevant information.

Costs to members

28. We do not foresee that this option would result in any additional costs to scheme members.

Benefits to providers

29. The removal of the indexation requirement will, it is estimated, result in a saving to insurance companies and pensions providers. We expect this option to affect around 10,000 people annually in the early years, rising significantly over time. Indexation only affects rights accrued since 1988, so the number of people retiring who would have been affected by indexation is fairly low at present. Occupational DC schemes have increased in prevalence (active members have increased by around 10 fold in the last couple of decades). This means that the 10,000 annual figure is likely to rise over time as successively larger numbers of members reach retirement age each year. Furthermore, it is possible that the shift away from DB provision towards DC provision will continue. This, along with an increase in Stakeholder pensions (whether through the workplace or otherwise, and as long as they contract-out) and a number of other factors suggest that the annual flow of annuitants is likely to increase significantly in the future.

[3] The open market option is the option at retirement, to have benefits secured by an annuity issued by an insurer of the member's choice. Under current arrangements this option applies to personal pensions, from 6 April 2006 it will apply to all DC schemes.

30. At present, annuity providers have to keep records of the various parts of an individual's money purchase pot in order to comply with the legislative requirements. Ending the indexation requirements would offer some administrative savings to these providers. Contracted-in money purchase schemes could see the biggest savings as there will be no other requirements to keep parts of the pot separate (as there are no protected rights). However, for other providers, there will still be requirements to calculate protected rights annuities on a unisex basis, and with a survivors benefit where applicable, so the administrative savings may be more modest. Under the assumption that the unit cost to pension providers of setting up an annuity is £100, and assuming that removing the indexation requirement will reduce this by 10% for a pension pot with protected rights and by one third for a contracted in pension pot with post 1997 rights, **the overall annual savings in the first year could be of the order of £0.2m**. This would increase in the future at the same rate as the number of annuitants affected.

Benefits to members

31. Unlike DB schemes where indexation of pensions in payment is factored into the funding of the scheme, individuals in DC schemes pay for indexation on retirement when purchasing an index-linked annuity. As a result of this option, individuals with DC pensions will still be free to choose to purchase an index-linked annuity but they will not be compelled to do so (unless scheme rules still require them to do so). They will not have to divide their pension pot in to different tranches and purchase different annuities with each component pot. Individuals will have a greater degree of choice and the information provided to them should enable the member to make an informed choice. If the member chooses to purchase a level annuity the main benefit will be a higher headline pension. If they wish they will be able to purchase an indexed-linked annuity when they consider these to be good value, relative to their assessment of the possible risks to their income of future inflation. They should also benefit from the greater efficiency in the annuity market as bureaucracy is cut for providers and the savings to firms may lead to a small improvement in annuity rates over time.

Option 3

32. Doing nothing would not address the complexity currently faced by providers and occupational schemes in administering the complex indexation regimes in DC pensions. Scheme members will also continue to have limited choices and options available to them at the point of retirement to decide how to structure their retirement income.

Business sectors

33. The business sector that will be affected most by these proposals will be the financial sector, in particular insurance companies and pension providers. There will also be some effect on employers sponsoring occupational DC schemes.

Equity and fairness

34. The Government do not believe that these proposals will have a disproportionate effect on any particular group of individuals. All members of DC schemes will, if they choose a level annuity, benefit from an increased headline pension.

35. These proposals will not have any race equality aspects.

Public Sector costs

36. There will be no increase in Public Sector costs as a result of these proposals. The GAD Survey[4] showed that there are no occupational DC schemes sponsored by Public Sector employers.

[4] Government Actuary's Survey (GAD)(2000) 'Occupational pension schemes 2000. Eleventh survey by the Government Actuary'.

Competition assessment

37. The Government has assessed the impact that these proposals will have and concluded that there will be no adverse effect on competition. As highlighted above, the business sector most affected by these proposals will be the financial sector, particularly the insurance sector.

38. Currently there are 160 insurance companies authorised to undertake long-term insurance business, including life insurance and pensions, and a further 54 composite insurance companies authorised to undertake both. The long-term insurance market is not heavily concentrated and the largest 10 companies account for only 68% of the market. This is in comparison to other insurance markets, for example the largest 10 property insurers make up 85% of that market[5].

39. The options outlined above combined with the introduction of the open-market option from 6 April 2006 should have a positive effect on consumer choice as individuals will have greater flexibility to choose an annuity and pension provider.

Impact on small business

40. The GAD survey[6] highlighted that of approximately 45,000 private sector DC occupational schemes, approximately 39,000 of these had between 2 and 11 members. The implication drawn from this is that these schemes are sponsored by small employers and companies. However, the Government does not foresee an adverse affect on small business as the costs to schemes resulting from the proposals set out above will be small.

Enforcement and sanctions

41. The options set out above would be regulated by the Financial Services Authority (FSA) and The Pensions Regulator. FSA rules already require that certain information, similar to that proposed under option 2 above, is sent out to scheme members by pension providers. Non-compliance with these rules could ultimately result in the FSA taking disciplinary action against the firm. OPRA currently has the responsibility for ensuring that occupational DC schemes meet the requirements set out in legislation. From 2005 the Pensions Regulator will take over this role and will ensure that occupational schemes comply with any legislative requirements under the options set out above by setting out that scheme trustees must produce a declaration that information has been sent to the member. Non-compliance with these rules could result in a fine being imposed or, if applicable, a trustee being removed or appointed.

Monitoring and review

42. The Government will monitor the effect that the options will have by monitoring the rate of increase in RPI and by assessing the effect on the annuity market by

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[5] The UK insurance industry: Key Facts. Association of British Insurers (ABI) website. www.abi.org.uk

[6] Government Actuary's Survey (GAD)(2000) 'Occupational pension schemes 2000. Eleventh survey by the Government Actuary' p8.

analysing whether, given the choice, members opt for a level or index-linked annuity. The Government will also undertake analysis and research on the effects that these options could have on State income related benefits. The FSA will also continue to monitor compliance by pension providers with the requirement to send out information to scheme members.

Consultation

43. The Government has consulted with the FSA in developing these options and analysing the likely impacts.

44. The Government has consulted on the draft regulations and this Regulatory Impact Assessment.

Summary

45. The table below summarises the costs and benefits of the options set out above:

Option	Total cost per annum Economic, environmental, social	Total benefit per annum Economic, environmental, social
1. Remove the requirement to provide mandatory indexation in DC schemes for rights accrued on or after 6 April 1997	• Additional cost to schemes and providers resulting from the requirement to reconfigure systems. • Small additional costs to schemes from the requirement to send out additional information to scheme members.	• This option would also benefit members by providing a greater degree of choice and flexibility at retirement to decide how to structure their retirement income derived from post 6 April 1997 benefits. • If they choose a level annuity for that part of their benefits derived from post 6 April 1997 rights they would receive a higher headline pension.
2. Removal of the requirement to purchase an index-linked annuity in DC schemes; and to mitigate the risk of this option, require that providers and schemes send out	• The requirement to send out additional information to scheme members may result in a small cost to schemes (mainly occupational DC) and their	• The Government estimates that this option would result in a saving to schemes and providers of around £0.2 million. • This option would also benefit members by

information to scheme members detailing the choice of annuities available.	sponsoring employers and providers who do not already do this.	providing a greater degree of choice and flexibility at retirement, and if they choose a level annuity, a higher headline pension.
3. Do nothing	• This option would not address the risks set out in paragraphs 8-10 above.	

46. The Government's objective is to simplify the indexation arrangements as they currently apply to pensions derived from money purchase benefits whilst also providing scheme members with a greater degree of flexibility and informed choice.

47. The Government has decided to proceed with **Option 2** as this would provide the greatest simplification of the current regime by removing any mandatory requirement to provide indexation on pensions derived from money purchase benefits. This would provide scheme members with a greater degree of flexibility and choice at the point of retirement. Requiring schemes and providers to send out information detailing the choices available to scheme members will also help members make an informed choice on the options available to them.

Ministerial Declaration

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed Malcolm Wicks

Date 16 March 2005

MALCOLM WICKS MP

Minister of State for Pensions

Department for Work and Pensions