Board for Actuarial Standards

Amending TM1 for revised contracting out provisions: Consultation Paper

December 2008

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1 INTRODUCTION

1.1 Since 6 April 2003 certain money purchase pension arrangements have been required to provide members with Statutory Money Purchase Illustrations (SMPIs). Legislation requires that SMPIs are produced in accordance with guidance prepared by a prescribed body approved by the Secretary of State for Work and Pensions and by the Department for Social Development in Northern Ireland. The Board for Actuarial Standards (BAS) was appointed as the prescribed body with effect from 6 April 2007. It fulfils its requirements through the publication of *Technical Memorandum 1: Statutory Money Purchase Illustrations* (TM1).

1.2 Over the coming months, the BAS intends to carry out a detailed review of TM1 taking account of changing market conditions, improving life expectancy and feedback resulting from experience of SMPIs to date. Any amendments to TM1 resulting from this review are likely to be made with effect from 6 April 2010 or 6 April 2011.

1.3 However, there are two changes affecting pension arrangements which are contracted out on a money purchase basis that require more immediate review. These are the proposed abolition of money purchase contracting out and changes to the earnings used to calculate contracting out rebates.

1.4 This paper sets out the BAS's proposals for amending TM1 to take account of these two changes, which are addressed in sections 2 and 3 respectively. Section 4 considers the communication of the changes to the recipients of SMPIs, and section 5 describes the arrangements for consultation. The Appendix gives details of the key changes to the text of TM1.

2 ABOLITION OF MONEY PURCHASE CONTRACTING OUT

2.1 Section 15 of the Pensions Act 2007 abolishes contracting out on a money purchase basis with effect from an "abolition date", which is "such day as the Secretary of State may by order appoint". The Government has stated that it aims to introduce this change in April 2012 or at the end of the Parliament at the latest. This means that the latest date for the introduction of the change would be during 2015. Currently TM1 requires an assumption that individuals remain contracted out until retirement, or State Pension Age if earlier, when calculating projected pension figures for SMPIs.

2.2 The BAS has considered how the proposed abolition of contracting out should be taken into account in SMPIs. We believe that, although there is some uncertainty about the precise date of abolition, SMPIs should reflect the change. Our view is that rebates should be assumed to continue until 2012, which we understand is the anticipated abolition date. If the Government announces that the abolition of money purchase contracting out is to be effective from a different date, then SMPIs prepared after that announcement should be based on rebates being paid to that different date.

2.3 An alternative approach that has been suggested is that SMPI calculations should assume that no further rebates would be accrued after the date of the SMPI. This would, it has been suggested, be easier to implement than the approach described in paragraph 2.2, in part because no further amendments would be required if the proposed effective date for the abolition of money purchase contracting out were to change. If this approach were adopted, SMPIs would need to include an explanation that future rebates were excluded.

2.4 While the BAS understands the administrative attractions of the alternative approach it believes that the interests of the recipients of the illustrations are best served if the illustrations reflect the available information about the likely payment of rebates. We are therefore proposing to amend TM1 so that projections are based on rebates payable up to the abolition date, or up to 2012 if the abolition date has not yet been set by the Secretary of State. This will mean that projections in SMPIs will reflect the Government's latest published aim to abolish contracting out in April 2012 or by the end of the Parliament at the latest.

2.5 We propose to make the amendments to TM1 with effect from 6 April 2009 so that they will apply to SMPIs issued after that date.

3 CONTRACTED OUT EARNINGS

3.1 The Pensions Act 2007 also brought in changes to the State Second Pension which will affect the amount of rebates received by contracted out pension arrangements. It is intended that the State Second Pension will become a flat rate pension around 2030. Rebates are currently calculated using earnings capped by the Upper Earnings Limit (UEL). As part of the transition the UEL will be replaced for this purpose by the Upper Accrual Point (UAP). Unlike the UEL, the UAP will be fixed (at £770 per week) and therefore the earnings on which rebates are based will gradually be eroded. It was originally intended that the UEL would be replaced by the UAP in 2012 but the Government has brought forward the change to 6 April 2009 in the National Insurance Contributions Act 2008.

3.2 The BAS believes that because the legislation has already been enacted these changes should be taken into account in SMPIs. We are therefore proposing to amend TM1 so that in projecting future rebates it should be assumed that rebates are based on earnings up to the UAP, which is fixed at £770 per week.

3.3 Appendix B of the current version of TM1 includes examples of rebate calculations. These examples are now out of date and providers should by now be familiar with the calculations required for SMPIs. We therefore propose to remove the examples.

4 COMMUNICATIONS

4.1 The change proposed in paragraph 2.4 will mean that for some recipients of illustrations the projected pension shown in the statement issued in 2009/10 will be less than that shown in the previous statement. The 2009/10 statement should therefore include an explanation of the change and the reason for it.

5 CONSULTATION

5.1 The BAS invites the views of those stakeholders and other parties who wish to comment on the content of this document. In particular the BAS would welcome views on the following:

1 Do respondents agree that the proposals set out in paragraphs 2.4, 3.2, 3.3 and 4.1 serve the interests of the recipients of SMPIs by ensuring that the illustrations reflect the best available information about the likely payment of rebates? Respondents who do not agree should present an alternative approach, explaining (with supporting evidence) why it would better serve the interests of recipients of SMPIs.

2 Do respondents have any comments on the proposed changes to TM1 set out in the Appendix?

RESPONSES

5.2 The BAS appreciates that there are time constraints that affect the implementation of changes to SMPIs. We would like to make a decision on amendments to TM1 as soon as possible. Comments on the proposals should therefore reach the BAS by **22 December 2008**.

5.3 For ease of handling, we prefer comments to be sent electronically to **basTM1@frc.org.uk.**

Comments may also be sent in hard copy form to:

The Director
Board for Actuarial Standards
5th Floor, Aldwych House
71-91 Aldwych
London
WC2B 4HN

5.4 All responses will be regarded as being on the public record unless confidentiality is expressly requested by the respondent. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure. We do not edit personal information (such as telephone numbers or email addresses) from submissions; therefore only information that you wish to publish should be submitted. If you are sending a confidential response by e-mail, please include the word “confidential” in the subject line of your e-mail.

5.5 We aim to publish non-confidential responses on our web site within ten working days of receipt. We will publish a summary of the consultation responses alongside our decision.

5.6 The BAS hopes to publish an amended version of TM1 in January 2009, which would take effect in April 2009.

APPENDIX – PROPOSED CHANGES TO TM1

A.1 The changes proposed in this consultation would result in a number of amendments to TM1. These include revisions to paragraph 4.6.4 and paragraph 19, additions to Appendix A and a new Appendix B. The proposed changes are set out below. There will also be consequential changes to the contents and other pages and paragraphs 2.3.2 and 2.3.3 will be deleted.

PARAGRAPH 4.6.4

A.2 Paragraph 4.6.4 will be replaced by:

> "*Illustrations* must also assume that the *Member's* contracted-out status as at the *Illustration date* relevant to the *Scheme* will continue to the earliest of *Abolition date*, *Retirement date* and State pension age. The Pensions Act 2007 provides for the abolition of money purchase contracting-out with effect from the *Abolition date*. For the purposes of TM1 *Abolition date* should be assumed to be 6 April 2012 unless some other date has been appointed by order of the Secretary of State in which case that date should be used. *Providers* who wish to do so may take account of any decision by the *Member* after the *Illustration date* and before the issue of the *Illustration* to change contracted-out status."

PARAGRAPH19

A.3 Paragraph 19 will be replaced by:

"19 Contracted-out rebates

19.1 Contracting-out assumption

If the *Provider's* records show that at the *Illustration date* the *Member* was contracted-out of the State pension arrangements under the *Scheme*, the *Provider* must assume that the *Member* will remain contracted out until the earliest of *Abolition date*, *Retirement date* and State pension age (see paragraph 4.6.4). *Providers* must also assume that contracted-out rebates will cease on the earlier of the *Abolition date* and the 5th day of April which is or next precedes the *Retirement date* or the *State pension age* (if this precedes the *Retirement date). Providers* who wish to do so may take account of any decision by the *Member* after the *Illustration date* and before the issue of the *Illustration* to change contracted-out status.

19.2 Determining contracting-out rebates

If

- under the *Scheme* the *Member* is contracted-out of the State pension arrangements

and

- future rebates are to be invested in the *Scheme* for the benefit of the *Member*, then future rebates must be accumulated to the *Retirement date* (see paragraphs 7.1 and 7.2). They must be determined in accordance with Appendix B and consistently with the increases assumed in the *Member's* earnings.

APPENDIX A

A.4 Paragraphs A.2.3.1, A.2.3.6 and A.2.9.2 will be amended to reflect the assumption that the member remains contracted-out until the earliest of *Abolition date*, *Retirement date* and State pension age.

A.5 There will be a new paragraph A2.9.4 as follows:

"Where a member is contracted-out, the *Provider* should consider providing an explanation that defined contribution contracting out is to be abolished with effect from 2012 or such other date as the Government decides. The *Provider* should consider providing an explanation of the impact of this change on *Illustrations.* This may include an explanation of the difference in treatment between illustrations provided before and after the change and some commentary on the financial implications."

APPENDIX B

A.6 Appendix B will be replaced by:

"APPENDIX B: PROJECTED CONTRACTED-OUT REBATES

B1.1 General

For the purposes of paragraph 19, the amount of National Insurance contracted-out rebates for Appropriate Personal Pensions (APPs) and Contracted-out Money Purchase Schemes (COMPS) should be calculated by multiplying an age- and year-specific rebate rate, expressed as a percentage of relevant earnings, by the amount of relevant earnings. Relevant earnings in a year are earnings between the annualised Lower Earnings Limit (or Qualifying Earnings Factor (QEF)) and the annualised Upper Accrual Point (UAP). The Low Earnings Threshold (LET) is used to determine the earnings bands applicable to APPS. Where age-related rebate rates (as a percentage of relevant earnings) have been specified for the relevant financial year in Orders made under the Pension Schemes Act 1993, *Providers* must use these rates. For years beyond those covered by the most recent Order (2012-13 and later), figures for rebate rates as a percentage of relevant earnings for all relevant future years should be obtained from the Government Actuary's Department (GAD) website, at www.gad.gov.uk.

B1.2 Determination of relevant earnings

The LET should be assumed to increase each year in line with the increases assumed in the *Member's* earnings. The QEF should be assumed to increase each year in line with the increases assumed in the *RPI. UAP* is flat rate and no increases should be applied to it.

B1.3 Timing of rebate payment – Appropriate Personal Pensions (APPs)

Rebates for APPs should be assumed to be paid by the National Insurance Contributions Office into the *Member's* fund in the middle of the tax year following the year of earnings to which they relate.

B1.4 Tax relief element paid along with contracted-out rebate (APPs)

Allowance should be made for the payment of notional tax relief on the employee's share of the rebate for APPs. This is calculated as

1.6% x (basic rate of income tax / 1 - basic rate of income tax) x relevant earnings

and is paid with the rebate. This should be based on the current basic rate of income tax. While the basic rate of income tax should be used in this context for all *Members* of APPs, regardless of their actual marginal rates of income tax, *Providers* should, in accordance with paragraph 18.1, take into account any known changes in the basic rate of income tax.

B1.6 Timing of rebate payment – Contracted-out Money Purchase Schemes (COMPS)

Part of the rebate for COMPS is paid after the end of the tax year by the National Insurance Contributions Office direct to the *Scheme*. The other part should be assumed to be paid into the *Scheme* during the year on a uniform monthly basis. The amount paid into the *Scheme* during the year should be assumed to be (for the 2009-10 tax year – the figure will vary for future tax years) 3.0% of relevant earnings, and the amount payable after the end of the tax year should be calculated as:

(Total rebate rate (obtained from the GAD website) - 3.0%) x relevant earnings

The amount payable after the end of the tax year should be assumed to be paid in the middle of the tax year following the tax year of the earnings to which they relate. "

Financial Reporting Council
5th Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN
Tel: +44 (0)20 7492 2300
fax: +44 (0)20 7492 2301
Website: www.frc.org.uk