Cabinet Office

Civil Service Pension Scheme

Consultation on proposed changes to Defined Contribution arrangements effective from April 2015

August 2014

Civil Service Pension Reform

Introduction and scope of consultation

1. This consultation covers the Defined Contribution (DC) arrangements in the Civil Service pension scheme. The arrangements cover:

   - Partnership pension arrangements
   - Ill-health benefits for members of Partnership
   - Death benefits for members of Partnership
   - DC Additional Voluntary Contribution (AVC) scheme (which is separate from Added Pension and Added Years which are Defined Benefit (DB) AVCs).
   - Stand-alone Stakeholder Pension arrangements

2. For the avoidance of doubt, no part of this consultation affects the pension arrangements for members of the main sections of the current pensions scheme, ie, *classic, classic plus, premium* or *nuvos* nor any of the post 2015 pension arrangements for members of the principal scheme.

3. We invite responses to this consultation about any aspect, and have included questions throughout the consultation about areas where we would particularly welcome views. Respondents should cover the full range of the consultation in their responses, and not feel limited to responding only to the specific questions.

4. This consultation is about the policy structure of the DC arrangements, and not about the individual providers, charges or investment choices which are regularly reviewed by the Pension Scheme Executive.

Timetable

5. Cabinet Office will accept responses until Monday 3rd November 2014. Cabinet Office will then publish its response, which will give final details of the approach to be adopted and implemented from 1 April 2015.

Background

Existing DC arrangements

6. There are currently 3 aspects to the DC arrangements:

- DC AVCs (13,307 members, £214m funds) provided by Standard Life (26% of funds), Scottish Widows (66%) and Equitable Life (8%).

- Partnership (7,540 members, £125m funds) provided by Standard Life (20% of funds), Scottish Widows (58%) and TUC/Prudential (23%)

- Stand-alone Stakeholder provision (666 members, £17m funds) provided by Standard Life.

(all statistics as at 31st December 2013)

7. The DC arrangements are small in comparison to the main DB scheme, which has around 500,000 active members.

Chart 1: Distribution of DC funds

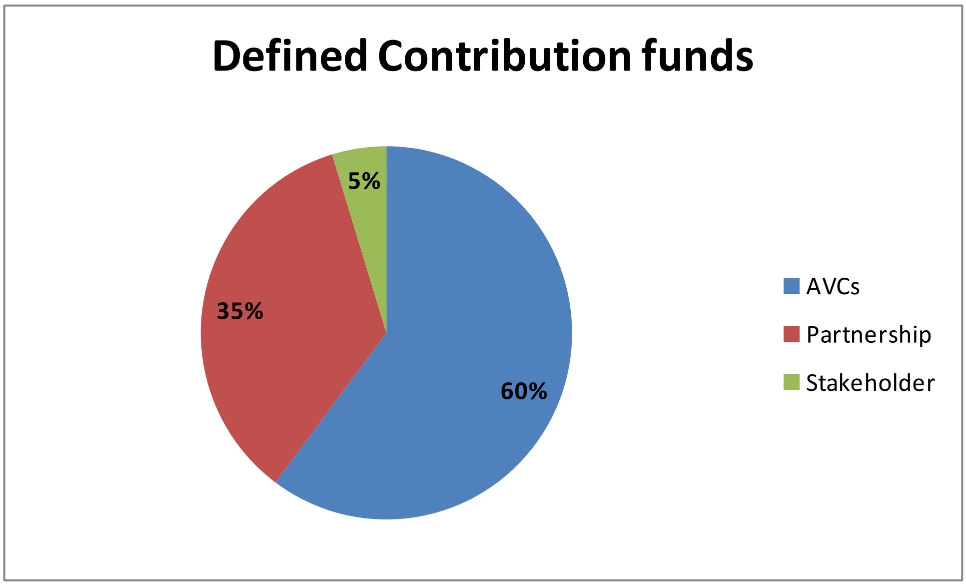
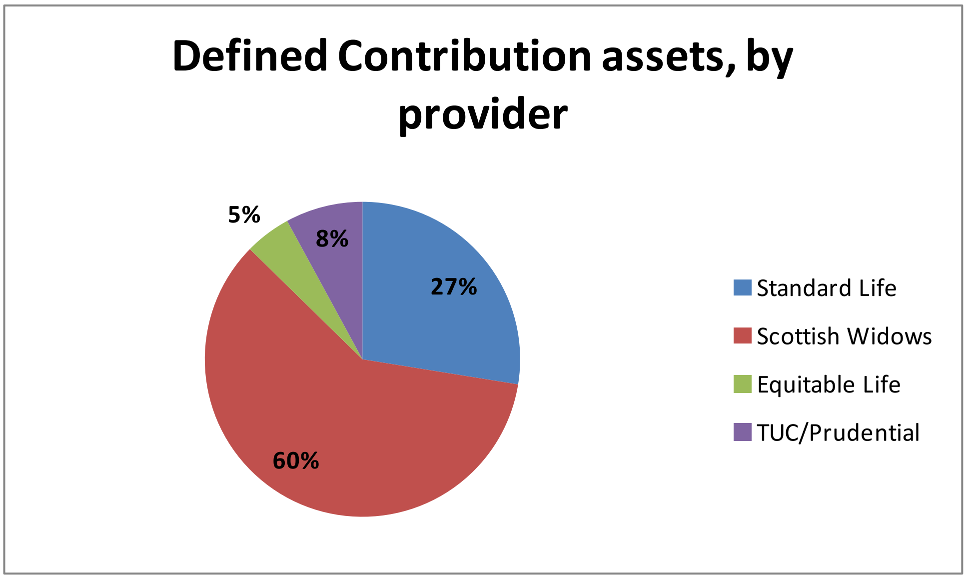


Chart 2: Providers of DC, by funds invested



Reasons for proposed changes

8. Many of the DC arrangements were introduced in 2002 or earlier, and have seen little change since their introduction.

9. Since 2002 there has been much change in pension arrangements in the principal scheme, with the introduction of *nuvos* in 2007, changes from RPI to CPI revaluation and indexation, changes to the discount rate used across public service pension schemes and changes to member contributions. From April 2015, most new and existing members will join *alpha,* the new post 2015 pension scheme[1].

10. There have also been many changes to the taxation arrangements for DC pensions in recent years, particularly at Budget 2014 which introduced significant flexibility in how pension benefits from DC pensions can be taken in future, allowing the entire pot to be taken if that is the member's desire. Currently, the rules of the AVC scheme do not permit the changes to the rules about small pot commutation and the post 2014 flexibilities, so there is a need to bring the rules up-to-date.

11. The reason for change is not about reducing costs – indeed, the employer contributions are proposed to increase. In some areas member benefits will be changed to be brought into line with the arrangements in *alpha*. An example of this is the death-in-service benefit, which currently provides a lump sum payment of 3 times salary (the same as *premium*) whereas the post-2015 scheme provides 2 times salary.

[1] Further details of *alpha* can be found at http://www.civilservice.gov.uk/pensions/reform/2015-changes

Summary of Recommendations

Partnership, including ill-health and death benefit schemes

1. Increase employer contribution rates to reflect the value of post 2015 Defined Benefit scheme, retaining most of the existing age tiers.
2. Introduce a minimum employee contribution rate of around 2.5% (the same rate applying to all members) set at a level to ensure that all members pay at least 8% of their pensionable pay into their pension as a result of employee contributions, employer contributions and basic rate tax relief. The increase to be phased in over 2 years to mitigate the impact on existing scheme members. All of the extra contributions will go into individual's pension pots and lead to a larger pension pot at retirement – the Exchequer will not receive any of this additional contribution.
3. Extend eligibility to employees recruited prior to 2002 who are eligible to participate in *alpha* (the main section of the post 2015 Civil Service pension scheme), but not until a future date (probably April 2016). Members with Transitional Protection who remain in existing schemes and who joined prior to 2002 will remain ineligible to join Partnership.
4. Death-in-service benefits to be reduced from 3 times salary to 2 times salary
5. Earnings cap to be removed.
6. No significant change to ill health benefits, although some amendments required, for example to change age references from 60/65 to State Pension age.

AVC Scheme

1. Amend rules of AVC scheme to be consistent with new pension decumulation regime which will apply from April 2015.
2. Remove annuity guarantee offer from AVC scheme (members who are currently eligible will be protected)

Proposed post 2015 employer contribution rates

12. The table below shows the proposed Partnership employer contribution rates from 2015. The contribution rates are based on actuarial advice, and are intended to be similar to the cost to the Exchequer of providing the main scheme pension for members choosing to participate in Partnership instead.

Table 1: Proposed employer contribution rates post 2015

Age band	**Current structure**	**Matching voluntary member contributions up to 3%**	**No matching contributions**
≤ 20	3.0%	5.5%	6.0%
21-25	4.5%	5.5%	6.0%
26-30	6.5%	7.0%	7.5%
31-35	8.0%	9.0%	9.5%
36-40	10.0%	11.0%	12.5%
41-45	11.5%	13.5%	15.5%
≥ 46	12.5%	16.0%	18.5%

13. Partnership currently does not require any employee contribution, although employee contributions are matched up to 3%.

14. The default proposal is the shaded column, retaining matched contributions. However, Cabinet Office is open to removing matched contributions and instead offering the higher base employer contribution shown in the table. Both options have been calculated by the Scheme Actuary as being of equivalent cost to the Exchequer.

15. Note that as there are very few members aged under 21, we propose to amalgamate this band with the 21-25 age band, to create a single band for all members younger than 26.

Guiding principles for proposed changes

16. The proposed changes are based on the following principles:

    I. The scheme should meet automatic enrolment requirements for existing members[2].

    II. The employer contribution of the DC scheme should be equivalent to the value of the pension the member would accrue in the 2015 scheme[3] less the member contribution

    III. Ancillary benefits (death and ill-health) should wherever possible be aligned to those offered in the 2015 scheme

    IV. The scheme should be a good quality DC alternative to the main scheme for members

    V. The scheme should be as simple as possible, unless there is a clear justification for additional complexity.

[2] The scheme will not be automatic enrolment compliant for new members, as a member decision about which provider to use is required, whereas automatic enrolment requires that a member does not have to take any decisions.
[3] This is not the same as the employer contribution rate to the 2015 scheme.

Detailed discussion of proposed changes

Employee and employer contribution rates

Tiered employer contributions

17. Currently employer contributions are higher for older members, reflecting that DB schemes are more generous for older employees. This is permitted by a specific exemption within UK age discrimination legislation where the difference meets specified aims.

18. The current tiered contribution structure mirrors the DB nature of pension provision which tends to be more beneficial for older members. This is an inherent feature of most DB arrangements in both the public and private sectors.

19. Whilst in the private sector a single contribution rate regardless of age is common, it is also normal for there not to be a choice of DB pension provision available. If the Civil Service Scheme were to offer a single contribution rate based on the average scheme membership profile, younger employees are likely to benefit from being in the DC scheme rather than the DB scheme at the start of their employment, moving into the DB scheme later in their career if they remain in the same employment.

20. <u>Therefore, there is a compelling argument to retain a contribution structure that is tiered by age.</u>

Q1: Are there any compelling reasons to not tier employer contributions?

Matched contributions

21. Partnership is currently non-contributory, although employee contributions are matched up to 3%. This allows members who may be considering opting out of the main sections of the Civil Service pension scheme a choice that will still ensure they have a future pension if they believe they cannot afford the pension contributions in the DB sections.

22. An argument for matched contributions is that if members do not contribute to pensions, they may not value them. This would appear less valid for Partnership however, as the member has actively chosen to join the scheme, which suggests a degree of awareness and appreciation of the value of pension scheme membership.

23. One of the reasons a member may choose DC provision is that they are in danger of breaching their Annual Allowance. In this case, employee contributions would be very undesirable as the member would not receive tax relief on them, but would be taxed on the future pension income. Similar considerations apply for the Lifetime Allowance.

24. Removal of matching would also make employer costs of DC provision more certain.

25. However, removal of matching contributions may be viewed by some members as a cut to their pension arrangement rather than a re-distribution.

26. Therefore <u>this consultation proposes to retain the current structure of matching voluntary member contributions up to 3%. However, Cabinet Office is open to removing matched contributions and instead offering a higher base employer contribution, as set out in the table earlier in this document.</u>

Q2: Should matching of voluntary member contributions up to 3% be retained?

Automatic enrolment qualification – minimum employee contribution rates

27. Partnership currently meets the requirements of an automatic enrolment scheme for members already within the scheme. However, this will cease to be true when minimum automatic enrolment contribution rates start to be phased upwards in 2017.

28. This is because although Partnership already offers a 3% or greater employer contribution rate, there is no minimum employee contribution rate and therefore for younger workers the overall contribution rate can fall below the statutory minimum.

29. <u>An employee contribution rate of 2.5% (before tax relief, 2% net of basic rate tax relief) will be introduced, which we propose would be introduced over 2 years, at the rate of 1.25% in each year (which is 1% once basic rate tax relief is taken into account). This will ensure all members contribute a combined total of at least 8% of pensionable pay from a combination of basic rate tax relief, employer and employee pension contributions.</u>

30. This is higher than automatic enrolment statutory minimum requirements as contributions are based on all of pensionable pay rather than banded earnings, but the proposal meets the principle of simplicity as many members may not realize that the statutory minimum requirements can be based on banded earnings.

31. Older members will meet the statutory minimum requirements without any mandatory employee contribution. Although it would be possible to only have a mandatory employee contribution for younger members, it is again consistent with the principle of simplicity to have the same rate for all age groups, and this also leads to simpler administration of the scheme.

Q3:Are there desirable alternative options which ensure all members contribute at least the statutory minimum after 2018 which meet the principle of simplicity?

Expanding eligibility to pre 2002 joiners

32. Currently members joining before 2002 are not eligible to join Partnership. Around 50% of current staff joined prior to 2002 and Partnership has a take-up rate of about 3% of eligible members.

33. The increase in member contribution rates from April 2012, the introduction of *nuvos* in 2007 and the change in revaluation and indexation to CPI did not apply or affect Partnership. Despite these changing financial incentives there has never been a large influx of members into Partnership.

34. Given that many members will be moving to *alpha (*the post 2015 Civil Service pension scheme) in April 2015, it is proposed that eligibility for Partnership is expanded to cover any member eligible to participate in *alpha.*

35. However, employers have expressed concern over the operational impact of needing to process switching forms at the same time as implementing the move to *alpha,* when their support functions will already be stretched. Therefore, we recommend expanding eligibility but not until April 2016 at the earliest.

36. This means eligibility for Partnership is recommended to be:

From April 2015

- Any member who joined after 1st October 2002 (as now)

From April 2016 (provisional)

- Any member eligible to participate in *alpha* can choose to be in Partnership, regardless of their date of starting employment.

- Members eligible to participate in *classic, classic plus, premium*, or *nuvos* who started employment on or after 1st October 2002 are eligible to participate in Partnership.

- Those in *classic, classic plus, premium*, or *nuvos* who started prior to 1st October 2002 will not be eligible to join Partnership.

Q4: Is there any reason not to expand eligibility to pre 2002 joiners not in the protected groups?

Revise the partnership pension account death benefits scheme

37. Partnership currently offers death in service benefits, although these are not a legislative requirement. As they are part of pooled benefits they can be provided at a competitive rate, which is likely to be a cheaper rate than individuals could access such products in the retail market.

38. Due to the low probability of members dying or entering ill-health, the ancillary benefits (ill health plus death in service) are not expensive, with employers charged 0.8% of salary.

39. Payments under the current Death Benefits scheme will cease from 1 April 2015 due to the Public Service Pension Act 2013. Hence it would be necessary to revise the Death Benefits scheme if no changes were proposed.

40. Members could have a choice between lower contribution rates or the ancillary benefits. However, this introduces an element of selection and increases the administration and complexity, therefore offering a choice is not recommended.

41. Members appear to value the protection offered by the ancillary benefits, and there are no compelling reasons to change or remove the benefits.

42. However, it is appropriate to change the death benefits from 3 times salary to 2 times salary to be in-line with the death benefits under *alpha*.

Q5: Do you agree with the rationale and proposed changes to death benefits?

Earnings cap

43. Currently, Cabinet Office sets an earnings cap and employers can only pay contributions up to the earnings cap.

44. *Alpha* will not contain any earnings limits so there does not appear to be any need for an earnings cap in Partnership, and hence it is recommended the earnings cap is removed.

Q6: Is there any reason to retain an earnings cap?

Revise the partnership pension account ill-health benefits scheme

45. The Public Service Pension Act 2013 prevents payment of benefits under the PCSPS in respect of service from 1 April 2015 (except for the transitionally protected group). This includes the partnership pension account ill-health benefits scheme. Hence it would be necessary to revise the scheme even if no change was proposed.

46. The ill health benefits offer a lump sum calculated by taking 20% of pensionable pay per year of Partnership accrual, capped by the lower of (i) 300% of pensionable salary and (ii) the amount of salary that would be earned by pension age (60 or 65).

47. It is recommended to change pension age to be equal to State Pension age, but make no other changes to the ill-health arrangements.

At retirement options in AVC rules to allow unfettered access to DC funds

48. The AVC rules prohibit drawdown and do not allow taking a small pension pot as a lump sum. It is proposed to change the rules to allow the flexibilities introduced by HMRC at Budget 2014 for the post 2015 DC environment.

Annuity guarantee

49. Currently, if a member purchases an annuity from any of the pension providers used by the scheme, the Minister provides a guarantee that in the event the provider fails, the Minister will ensure the pension is paid in full.

50. This guarantee appears better than the security offered under the Financial Services Compensation Scheme which protects other members in the event of provider failure. However, it is possible that if a sufficiently higher rate can be secured with an alternative provider it could result in a higher payment under the FSCS than would be paid under the Ministerial guarantee, even in the very rare event of provider failure.

51. The guarantee may therefore persuade members to take an annuity from one of the scheme providers when it would be more appropriate for them to use the open-market option to secure a higher rate.

52. It is also possible the guarantee could be argued to have State Aid/competition implications.

53. Given the guarantee may lead to poor member outcomes and would only be of value in very unusual circumstances, it is recommended to remove the guarantee. Note that those who have already annuitised and were eligible for the guarantee would retain the guarantee.

Q7: Is there any reason to retain the annuity guarantee, particularly given the changes announced in Budget 2014?

Q8: Are there any additional changes not discussed in this document which should be considered?

Summary of Questions

Q1: Are there any compelling reasons to not tier employer contributions?

Q2: Should matching of voluntary member contributions up to 3% be retained?

Q3:Are there desirable alternative options which ensure all members contribute at least the statutory minimum after 2018 which meet the principle of simplicity?

Q4: Is there any reason not to expand eligibility to pre 2002 joiners not in the protected groups?

Q5: Do you agree with the rationale and proposed changes to death benefits?

Q6: Is there any reason to retain an earnings cap?

Q7: Is there any reason to retain the annuity guarantee, particularly given the changes announced in Budget 2014?

Q8: Are there any additional changes not discussed in this document which should be considered?

Consultation responses

54. Responses should be emailed to pensionreform@cabinet-office.gsi.gov.uk or posted to:

Pension Consultation,
4th Floor,
Cabinet Office,
1 Horseguards Road,
London,
SW1A 2HQ.