

## **Consultation on the Draft Portability of Supplementary Pensions Directive 2005**

### **Response from Prudential plc**

Prudential plc provides pension schemes to over 4,000 companies in the UK. Our comments therefore reflect our position as a major provider of pensions to the UK corporate sector.

We are concerned that the Directive, as currently drafted, could have a significant negative impact on occupational pension provision in the UK and on worker mobility within and between member states. We believe the Directive needs to be amended and/or clarified to avoid these negative consequences.

In practice, we do not believe that the draft Directive, even after amendment, would have a significant impact on worker mobility. There are other factors that are much more significant to workers' in reaching a decision to move between employers.

#### **1) Key Points**

- 1.1 We believe that in most cases those looking to change jobs are more likely to be positively influenced by a new employer's pension provision, rather than deterred from moving by the treatment of their existing benefits. This is particularly the case for those at younger ages, or with short periods of service, where the value of benefits accrued is small.
- 1.2 It is therefore important for worker mobility that employers continue to offer pension provision to their workers. In this context the Directive must not result in a reduction in the number of employers willing to offer pension schemes.
- 1.3 Many occupational pension schemes are established for the purpose of rewarding employees and encouraging staff retention. The Directive must therefore balance the needs of early leavers with the need to ensure employers still perceive a value in providing a pension scheme for their workers. Without this balance the Directive could have a negative impact on worker mobility if it leads to fewer occupational schemes being provided.
- 1.4 Unfortunately, we are concerned that as currently drafted the Directive could have a significant negative impact on occupational pension provision in the UK. In particular we are concerned by the following requirements that could potentially apply under the Directive:
  - The Directive does not appear to specify that the right to a transfer under Article 6.1 does not apply after retirement. This could mean that the Directive creates a right to transfer after retirement. Such a right would have a significant negative impact on pension provision by increasing selection risks and costs for schemes and for annuity providers.
  - Article 6.2 could prevent schemes from reducing transfer values in circumstances where a reduction is appropriate to protect the scheme, the employer/scheme provider or other scheme members.
  - The scope of Article 6.3 is unclear in terms of what constitutes "vesting requirements" for a transfer. If this Article requires schemes to accept transfers-in then it would have a significant negative impact in the UK. For example, it would require schemes to accept unequalised benefits. It

could also mean that contracted-in schemes would have to accept contracted-out benefits.

- Article 6.3 could also be taken to mean that schemes would not be able to impose any conditions on the treatment of transfers-in. This could mean, for example, that Defined Contribution schemes would be unable to require transfers from Defined Benefit schemes to be treated on a Money Purchase basis. It may also prevent DWP legislation from specifying the form in which benefits can be taken from contracted-out funds following a transfer, and could prevent HMRC from imposing conditions on the transfer of funds from overseas schemes.
  - Article 6.4 would lead to employers, or those members who remain in service with an employer, subsidising the costs of early leavers.
  - Article 7.1 appears to extend schemes' disclosure requirements to all employees on leaving service, and not just those who are members of the scheme. This would create unnecessary expense and complexity for employers.
- 1.5 We believe that if the Directive has these effects it would have a significant negative impact on pension provision in the UK, and therefore would reduce rather than facilitate worker mobility.
- 1.6 If the Directive is to have any positive effect on worker mobility it is necessary to ensure that it:
- Does not apply to members once their benefits have commenced.
  - Allows Schemes and Providers to continue to reduce transfer values in appropriate circumstances, as currently allowed under UK legislation.
  - Allows schemes to continue to refuse to accept transfers-in, and for conditions to be attached to the acceptance of transfers.
  - Does not require the costs of early leavers to be subsidised by the employer or by those remaining with an employer.
  - Imposes disclosure requirements on schemes only in respect of workers who are scheme members.

## **2) Specific comments on the DWP Consultation document**

- 2.1 Paragraph 26 of the DWP Consultation document states that the Directive does not apply to the termination of employment on retirement. However there does not appear to be anything in the Directive that specifies this as the position.

Unless termination of employment is adequately defined we are concerned that the Directive could inadvertently give members a right to transfer after benefits commence. This would have a significant negative impact on retirement income provision by changing the lifetime nature of the benefits secured. The costs of investment uncertainty and the need to implement procedures to prevent selection against the pensioner or annuity pool would mean that costs would rise and incomes fall.

The Directive therefore needs to be clear that scheme members do not have a right to a transfer once benefits commence and that termination of employment does not include termination through retirement.

- 2.2 The wording used in paragraph 43 of the Consultation document is potentially misleading in its description of the requirements under Article 6.1 of the Directive.

In paragraph 43 it states “If a transfer is requested by the worker, this article requires the transfer to take place within 18 months”.

To correctly describe the position under the Directive the words “of the termination of his employment” should be added to the end of this sentence.

- 2.3 Paragraph 40 of the DWP document states that the UK is not intending to use the option under Article 5.2 to give schemes the right to transfer vested rights as an alternative to leaving them within the scheme.

However Recital 8 of the Directive states “pension schemes must be given the option not to preserve acquired rights but to use a transfer or payment of a capital sum ... when these do not exceed a threshold established by the Member State...”.

On the basis of the Recital it would appear that the effect of the Directive could be to require Member States to permit this option (subject to certain conditions). It is important that the position under the Directive is clarified.

### **3) Answers to specific questions raised by the DWP**

#### **1) Do you think that the proposed Directive will better facilitate the free movement of workers within the EU?**

We believe those looking to change jobs are more likely to be influenced by a new employer’s pension provision, than by the future treatment of their existing benefits. This is particularly the case for those at younger ages, or with short periods of service, where the value of benefits accrued is small.

It is therefore important for worker mobility that employers remain willing to make pension provision for their employees. However we are concerned that the impact of the Directive as currently drafted would be to reduce the number of employers willing to provide an occupational pension.

It is also important to recognise that many employers currently offer pension schemes as a means of encouraging staff retention. In seeking to facilitate worker mobility it is important that the Directive does not cause employers to perceive a reduced value in providing pension schemes for their workers.

In terms of the impact of the Directive on worker mobility we believe that factors other than those covered by the Directive have a more significant impact on the ability or willingness of workers to move within or between member states.

For intra-state movement these factors include the availability of work, relative salaries & ancillary benefits (including pensions), working conditions and the ‘goodwill’ attaching to an employer.

For inter-state movement we believe factors such as language, culture, economic conditions, standard of living, employment rates and job/career opportunities,

personal taxation, state pension & social security provision and housing costs have a more significant impact on the movement of labour.

Therefore although we support the principles underlying the Directive, we are not clear how many people are currently restricted in their movement by the rules currently applying to supplementary pension schemes, nor how many people would change jobs as a result of the Directive.

We believe that the Directive could have a marginal positive impact on the free movement of labour, provided its requirements do not cause employers to stop providing pensions for their workers. However if it results in a reduction in occupational scheme provision it is likely to have a negative impact on worker mobility.

**2) Have you experienced reduced mobility for workers caused by the rules of supplementary pension schemes? If so, were the problems relating to worker mobility within the UK or between the UK and another Member State?**

We have not experienced reduced mobility caused by the rules of supplementary pension schemes. While we would expect pension provision to play some role in an employee's decision to change jobs, we believe the positive impact of a new employer's pension provision is likely to be a more significant factor than the treatment of existing benefits. This is especially the case for those at younger ages or with short periods of service where the value of benefits accrued is small.

**3) What schemes do you think are included in the scope of the Directive? Does the current definition capture any non-occupational pension schemes?**

We believe that the definition of "supplementary pension scheme" in the draft Directive should apply only to those schemes defined as "occupational pension schemes" in Section 1 Pension Schemes Act 1993.

The definition of "occupational pension scheme" in Section 1 Pension Schemes Act 1993 meets the requirements of Directive 2003/41/EC (the "IORPS" Directive). We therefore believe that the schemes covered by the definition of "supplementary pension scheme" in the draft Directive should be the same as those covered by Directive 2003/41/EC.

**4) Are there any schemes you think are included in the definition of a supplementary pension scheme that should not be? Are there any schemes that are not included that you think should be?**

As indicated above, we believe that the definition of "supplementary pension scheme" should apply only to schemes defined as occupational pension schemes in Section 1 Pension Schemes Act 1993.

We do not believe the Directive should apply to contract-based pensions such as Group Personal Pension Plans and Employer Stakeholder Pensions.

DWP will need to consider how the Directive would impact on any National Pension Savings Scheme when preparing their position on the draft.

**5) Are there occasions when employment is terminated by either party when the Directive should not apply?**

The Directive should not apply when employment is terminated by reason of retirement. As the concept of what constitutes retirement will become less clear as more employees 'downshift' or move to part-time employment etc, the Directive should specify that it does not apply once the member has started to receive benefits under the scheme.

**6) Are there any other terms that should be defined in the Directive?**

"Termination of employment" should be defined to exclude termination by reason of retirement.

"Retirement" should be defined as the commencement of benefit payments under the scheme.

**7) From April 2006, in UK law it is not mandatory to return employee contributions if the employee leaves within three months of joining the scheme. What would the effect be on UK schemes if this was made mandatory?**

**8) From April 2006 UK law will allow a scheme to refund the value of contributions after investment rather than total contributions if a member leaves before their pension rights vest. What would be the cost to schemes if it was mandatory to return contributions?**

We are concerned about the impact of these requirements on 'earmarked' money purchase schemes i.e. where each member has an identifiable 'pot' in their name. Under these schemes the only money available for refund on leaving service will be the value of the member's fund. In certain circumstances the value of the fund may be less than the value of the contributions paid. In this event we are not clear how the scheme would be able to refund more money than it actually has available.

We therefore believe that the Directive should specify that a member is only entitled to the return of the current value of their pension contributions.

For all types of scheme, the Directive should not entitle members who leave service to the refund of life cover premiums paid while a member of the scheme. The Directive should therefore exclude any right to a refund of contributions paid as premiums for life cover under the scheme.

**9) What would the cost be to UK schemes if a minimum entry age of 21 was imposed for all occupational pension schemes?**

We are unable to provide any estimate of the cost.

**10) What would be the cost to UK schemes if waiting times for all occupational schemes were limited to a maximum of one year?**

We are unable to provide any estimate of the cost.

**11) Do you think that the article as it stands will allow UK schemes to continue to uprate deferred pensions in line with price inflation up to a limit of 5%? If not, what amendments to the text would be required?**

Yes. There is a risk that the provisions of Article 5.1 could be interpreted as requiring dormant rights to increase in line with earnings. However the wording in Recital 7 and in Article 5.1 appears to provide member states with sufficient flexibility in interpreting how a “fair adjustment of dormant rights” can be achieved.

**12) What would the impact be on UK schemes if they were required to accept incoming transfers?**

If the effect of Article 6.3 is that schemes are required to accept a transfer-in we believe that it would have a significant negative impact on pension provision in the UK.

For example, a requirement for Defined Benefit schemes to accept transfers-in would increase the level of longevity risk being taken in respect of scheme members. This increase in risk may be greater than the employer is prepared to accept and could result in the discontinuance of the scheme.

A requirement to accept transfers-in would also be incompatible with UK legislation regarding the treatment of contracted-out benefits. For example, there would be significant issues with a requirement that contracted-in schemes must accept transfers of contracted-out benefits.

In addition such a requirement could, for example, require a scheme to accept the transfer of unequalised benefits or to accept a transfer value that was insufficient to meet a Guaranteed Minimum Pension (GMP) liability. This would mean that the receiving schemes would be required to take on the cost of equalising benefits or meeting the shortfall in GMP benefits. Employers will be unwilling to take the risk that these additional commitments could arise in respect of their employees and therefore could close their scheme.

We are also not clear if the effect of such a requirement would be that HMRC could no longer impose conditions on the treatment of transfers from overseas schemes. This would increase the potential for abuse of the UK pension taxation system.

We are also concerned that such a provision could result in the use of pension schemes for money laundering, especially where funds originate from outside the EEA.

We therefore believe that it is critically important that the Directive does not impose a requirement on schemes to accept transfers-in and does not prevent conditions being imposed on the treatment of transfers.

**13) How long is required by a pension scheme to complete a transfer?**

Our experiences with Money Purchase schemes are that, on average, transfers take between 4 to 6 weeks to complete after the member has decided to take a transfer and all relevant information has been provided. This period does not include the time taken by the member to decide whether or not to take a transfer and to return all relevant forms.

**14) In what circumstances (if any) should schemes be able to reduce transfer values? What would be the impact on UK pension schemes if they could not reduce transfer values in any circumstances?**

There are a number of important instances where transfer values must be capable of reduction:

- For schemes that are invested in with-profits funds the insurer must retain the ability to impose a Market Value Reduction in appropriate market conditions. Without this ability early leavers would be able to select against both the insurer, the remaining scheme members and/or the employer.
- If a scheme is under-funded on the insolvency of an employer it is essential that any transfer values reflect the funding position of the scheme. If they cannot then those seeking transfers would be getting a disproportionately higher pension benefit at the expense of remaining members, and/or the Pension Protection Fund.
- Schemes must be able to reduce transfer values to reflect adverse market conditions, for example a fall in the value of assets between receipt of a transfer request and the payment of a transfer.
- Schemes must be able to reduce transfer values to pay for the cost of transferring benefits. If they cannot then those who remain with an employer would be subsidising the benefits of early leavers.
- Providers must be able to reduce transfer values to recover up-front costs that would otherwise have been recovered over the period to retirement age.

We therefore believe that it is essential that the Directive continues to allow UK pension schemes to reduce transfer values, in appropriate circumstances, on the basis currently permitted under UK legislation.

**15) What impact would there be on UK schemes if they were unable to subject incoming transfers to vesting conditions?**

We believe the scope of Article 6.3 is unclear and are concerned that it could prevent any conditions being imposed on the treatment of transfers-in. This could mean, for example, that a Defined Contribution scheme would be unable to require a transfer from a Defined Benefit scheme to be treated on a Money Purchase basis. It could also mean that DWP legislation would be unable to specify the form in which benefits can be taken from contracted-out funds, following a transfer.

We are also concerned that such a provision could prevent HMRC imposing conditions for the acceptance of transfers from overseas schemes, leading to abuse of the UK pension taxation system. Such a provision could also increase the potential for the use of UK pension schemes for Money Laundering.

We therefore believe it is important that the scope of Article 6.3 is clarified and, if necessary, amended to remove these effects.

**16) Is it appropriate to compare pension rights transferred in to a scheme to dormant rights in the same scheme?**

We believe this approach is appropriate provided that it requires only that transferred benefits must be subject to the same preservation rules as apply to benefits accrued directly under the scheme.

**17) What is the normal administrative charge for a transfer and is this usually borne by the scheme or the outgoing worker?**

Transfers from With-Profits funds may be subject to a Market Value Reduction in appropriate market conditions. In addition transfers-out from Money Purchase

schemes may incur an 'early termination charge'. This charge represents the recovery of up-front costs that would otherwise have been recovered over the lifetime of the contract.

In small schemes these deductions are usually borne by the member, but in larger schemes they are usually borne by the scheme.

We do not believe that Article 6.4 should require that the administrative costs of a transfer should be linked to the member's length of service. Such a requirement would mean that those who remain with an employer, or the employer itself, is subsidising the costs of those who leave. We do not believe it is appropriate for the Directive to be creating this form of cross-subsidy for early leavers.

**18) Will the current draft of the Directive increase the obligations of Pension Schemes to provide information?**

We believe most of these requirements will already apply to occupational pension schemes once the 'Occupational Pension Scheme (Disclosure of Information) Regulations 2006' are laid provided that the word "workers" is replaced by "scheme members" in Article 7.

We are concerned that the draft Directive would appear to remove current exemptions from UK disclosure requirements, for example, in respect of single member schemes and death-in service only schemes. We believe these exemptions should be retained.

**19) How long would it take schemes to make the changes necessary to implement the Directive?**

This will depend on the impact of the Directive. For example, the impact will be significantly greater if the scope of the Directive extends beyond occupational pension schemes.

If the effect of the Directive is that more employers withdraw from scheme provision then time will be spent on scheme closures rather than on implementation of the Directive.

**20) Are there any circumstances in which you can conceive the UK wishing to use these exemptions?**

We believe the Directive should allow existing exemptions under UK law in respect of single member schemes and death-in-service only schemes to remain.

**21) Should schemes in wind-up be exempt from the Directive? What would be the impact if they are not?**

As described in response to question 14, under-funded schemes in wind-up must be able to reduce transfer values to avoid early leavers selecting against other scheme members or the Pension Protection Fund.

**Prudential plc  
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