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Implementing a cap on early exit charges for members of occupational pension schemes

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Summary

About this guidance

1. Regulation 6 of the Occupational Pension Schemes (Administration, Investment and Charges and Governance) (Amendment) Regulations (Northern Ireland) 2021[1] introduces restrictions on early exit charges for those aged 55 and over and who are eligible to access the pension freedoms. It amends the Occupational Pension Schemes (Charges and Governance) Regulations (Northern Ireland) 2015 to reflect these restrictions.

2. The amendments provide for the Department for Communities ("the Department") to issue statutory guidance on how the value of the member's benefits is calculated for the purposes of calculating the level of an early exit charge.

Relevant legislation[2]

- The Occupational Pension Schemes (Charges and Governance) Regulations (Northern Ireland) 2015 ("the 2015 Regulations").
- The Occupational Pension Schemes (Charges and Governance) (Amendment) Regulations (Northern Ireland) 2016.
- Regulation 6 of the Occupational Pension Schemes (Administration, Investment and Charges and Governance) (Amendment) Regulations (Northern Ireland) 2021 ("the 2021 Regulations").
- The Pensions Act (Northern Ireland) 2015.
- The Pension Schemes Act (Northern Ireland) 2021.

Who is this guidance for?

3. This guidance is for trustees and managers of occupational pension schemes and service providers. It provides information on how to calculate the level of early exit charges for the purposes of ensuring that the level of the charge imposed, or permitted to be imposed, on a member of an occupational pension scheme does not exceed the permitted limit.

[1] https://www.legislation.gov.uk/nisr/2021/272/contents/made

[2] https://www.communities-ni.gov.uk/services/law-relating-social-security-northern-ireland-blue-volumes

Legal status of this guidance

4. This statutory guidance explains how the limit on early exit charges for members of occupational pension schemes who joined before 1 October 2021 set by regulation 13C of the 2015 Regulations (as inserted by the 2021 Regulations) is to be calculated. Where there is a failure to comply with the legislation, including where an early exit charge exceeds the limit set by regulation 13C by virtue of a failure to correctly apply this guidance, the Pensions Regulator will consider taking enforcement action which includes the possibility of a financial penalty (see Part 4 of the 2015 Regulations).
5. For occupational pension schemes, the Pensions Regulator is responsible for helping employers to understand how to comply with the law. The Department is responsible for answering questions relating to the policy intentions behind the legislation. The Department cannot provide a definitive interpretation of the legislation which is a matter for the courts. Trustees and managers and service providers should consider the regulations to determine whether the new requirements apply to them, taking further advice where necessary.

Introduction

Overview

6. The introduction of the pension freedoms in April 2015 has given individuals aged 55 and over greater choice about how and when they access their pension savings. As a result, the pension freedoms have increased the attractiveness for individuals with non-flexible benefits of transferring or converting these benefits into a form which can be accessed flexibly.
7. However, it was recognised that individuals were facing a range of potential barriers when seeking to access their savings under the pension freedoms. This included incurring early exit charges which can act as a barrier to some people seeking access to their pension savings. To address this, a cap on early exit charges in occupational pension schemes was introduced.

Personal and stakeholder pensions

8. To ensure that early exit charges could be capped in personal pension schemes. The Financial Services and Markets Act 2000 was amended to give the Financial Conduct Authority ("FCA") a duty to make rules to limit early exit charges in personal and stakeholder pension schemes. From 31 March 2017, FCA rules[3] provide that:

[3] Pension Schemes (Restrictions on Early Exit Charges) Instrument 2016 (FCA 2016/72)

- early exit charges in existing pension schemes must not exceed 1% of the value of the member's benefits being taken, converted or transferred or the pre 31 March 2017 level, if lower;
- firms must not apply an early exit charge to personal pensions entered into after these rules take effect.

9. The restrictions apply when a consumer eligible to access the freedoms (because they have reached normal minimum pension age, typically age 55) takes, converts or transfers pension benefits before the expected retirement age.

10. In its July 2015 consultation Pension transfers and early exit charge the then Government proposed to exclude Market Value Adjustments ("MVAs") from the definition of early exit charges in personal and stakeholder pensions and set out its reasons for doing so. It subsequently introduced regulations The Financial Services and Markets Act 2000 (Early Exit Pension Charges) Regulations 2016. These provide that when specific conditions are satisfied adjustments made in the course of calculating the surrender value of a member's pension benefits, or adjustments to the means by which that value is calculated are not early exit charges for the purpose of the cap. Those regulations also provide that where a member has a reasonable expectation that they are entitled to the value of certain benefits, such as a terminal bonus, an adjustment to that value at the point of surrender is not excluded from the definition of an early exit charge (as defined in section 137FBB of the Financial Services and Markets Act 2000).

11. The FCA Rules which set out the cap on early exit charges provide that when calculating 1% of the value of the member's benefits being taken, converted or transferred for the purposes of limiting the early exit charge that may be imposed, the value of the member's benefits excludes MVAs but includes terminal bonuses and equivalent adjustments.

Occupational pensions

12. In May 2016, DWP published the consultation paper Capping early exit charges for members of occupational pension schemes – ensuring a fair and consistent approach across all defined contribution pensions. The Department issued the DWP paper to interested parties here as part of the consultation process. This consultation sought stakeholders' views on proposals to introduce a cap or ban on early exit charges imposed on members of occupational pension schemes who choose to leave the scheme early in order to access their pensions flexibly. The consultation response published on 15 November 2016 set out the intention to introduce and set a cap on early exit charges in line with that proposed by the FCA for personal pensions – 1% of the value of the member's benefits being taken, converted or transferred for existing members of occupational pension schemes and a ban on charges for new members of these schemes.

13. Consideration was also given as to whether MVAs and terminal bonuses should be excluded from the definition of early exit charges in occupational pension schemes. The approach taken for personal and stakeholder pensions was

considered and the conclusion was that MVAs and terminal bonuses should be excluded from the scope of the cap. However, as MVAs and terminal bonuses are not covered by the definition of an “administration charge” in Schedule 18 to the Pensions Act (Northern Ireland) 2015 there is no need to specifically exclude them in the legislation.

14. The response also stated that the intention was that the 1% cap will apply to the value of the member’s pension pot after any MVA has been applied and that in circumstances where there is a guarantee or “reasonable expectation” of a terminal bonus being paid then it was the view that this should be treated for these purposes as forming a part of the total value of the member’s pension pot.

Guidance

15. The difference between personal and stakeholder pension schemes and occupational pension schemes is recognised and that there are differences in the way they operate. However, it is clear that members of both personal and stakeholder pension schemes and occupational pension schemes should be treated equitably and not hindered from accessing the pension freedoms by prohibitive early exit charges.

16. The 2015 Regulations (as amended by the 2021 Regulations), amongst other things, sets out the definition of early exit charges and how these should apply to members of occupational pension schemes. The regulations also provide for the Department to issue guidance from time to time on how an early exit charge is to be calculated.

When does this guidance apply?

17. This guidance applies to the calculation of the 1% limit on early exit charges set out in regulation 13C of the 2015 Regulations (as inserted by the 2021 Regulations). It, therefore, applies in relation to any member of an occupational pension scheme who joined that scheme before 1 October 2021. It does not apply to any member of an occupational pension scheme who joined that scheme on or after 1 October 2021 as no early exit charges may be imposed on such members[4].

18. It also only applies where early exit charges currently exist. No new early exit charges may be imposed after 1 October 2021 where no such charge existed previously and existing early exit charges may not be increased to the permitted level[5].

[4] See regulation 13B of the Occupational Pension Schemes (Charges and Governance) Regulations (Northern Ireland) 2015 (S.R. 2015 No. 309) (as inserted by the 2021 Regulations).

[5] See regulation 13C(2)(b) and (3) of the Occupational Pension Schemes (Charges and Governance) Regulations (Northern Ireland) 2015 (as inserted by the 2021 Regulations).

Market Value Adjustments

19. MVAs, sometimes referred to interchangeably as Market Value Reductions, are adjustments generally found in "with profits" products or similar products, which are offered by insurers directly to members via personal pension schemes or indirectly via occupational pension scheme investments. They are reductions that may be made to the nominal value of a member's pension benefits when they exit a pension scheme early in order to more closely align them with the market value of the assets of which those benefits are comprised at the point at which the member exits the scheme.

20. The investments to which MVAs may be applied are long-term in nature and backed by asset models that assume continued participation to a particular point, usually the selected retirement age. Consequently, members leaving a scheme early could disrupt providers' long term asset models which are built to incorporate long-term factors such as changes in interest rates. This is demonstrated by the fact that MVAs tend to reduce or fall away entirely as a saver approaches their selected retirement date.

How are they to be treated?

21. MVAs are not covered by the definition of an "administration charge" in Schedule 18 to the Pensions Act (Northern Ireland) 2015 and so they are not included in the definition of "early exit charge" in the 2015 Regulations (as amended by the 2021 Regulations). Trustees and managers of occupational pension schemes and service providers are, therefore, not prohibited from or limited in applying MVAs by the early exit charge restrictions.

22. When a trustee or manager of an occupational pension scheme or a service provider is assessing whether a proposed early exit charge would come within the 1% cap, any MVA should be applied before calculating the value of the member's pension pot.

Terminal bonuses

23. There may be cases where a scheme member is entitled to a terminal bonus which could be either as a result of an express entitlement or a reasonable expectation arising under the scheme.

24. A terminal bonus is an additional bonus added to a with-profits policy which may be paid to the member when they exit the scheme, including if this is before their pension age under the scheme rules. The level of terminal bonus can vary by provider, as well as from year to year, and is based on the performance of the underlying investments at the point of the member's exit.

How are they to be treated?

25. Terminal bonuses are not a charge and so are not covered by the definition in Schedule 18 to the Pensions Act (Northern Ireland) 2015. They will, therefore, be

out of the scope of the cap on early exit charges for occupational pension schemes.

26. In circumstances where there is a guarantee or a “reasonable expectation” of a terminal bonus being paid, that bonus should be treated for these purposes as forming a part of the total value of the member’s pension pot. Therefore, when a trustee or manager of an occupational pension scheme or a service provider is assessing whether a proposed early exit charge would come with the 1% cap such a terminal bonus should be applied before calculating the value of the member’s pension pot.

Other charges

27. Notwithstanding that MVAs and terminal bonuses are excluded from the scope of the cap, any other exit charges derived from occupational pension scheme investments in “with profit funds” will still be captured by requirements of the cap. The rationale for this was to ensure that no member of any occupational pension scheme is disadvantaged with regard to being able to access the pension freedoms.

28. This is a comparable approach to that taken in relation to personal and stakeholder pensions.