

PENSIONS POLICY INSTITUTE

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The Pensions Primer

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The Pensions Primer

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An introduction to the current UK pension system

The pensions landscape in the UK is complex. The foundations of the UK pension system were laid in the 1940s. Since the 1960s, successive governments have changed both the state and private pension elements.

More recently, in 2006, the Government published two White Papers¹ outlining its intentions for reform of state and private pensions. The first phase of reform, to the state pension system, was introduced in the Pensions Act 2007. The second phase of reform, mostly relating to private pensions, is detailed in the Pensions Bill 2007/8, which is currently being scrutinised by Parliament.

This *Pensions Primer* gives a detailed description of the current pensions system and how it operates. This first section is an overview of the three tiers of the UK pension system. Subsequent Reference Notes (RNs) provide detail on many of the points covered.

This *Pensions Primer* differs from previous editions in that it outlines changes that will come into place in future as a result of the Pensions Act 2007 and changes that will come into place if the Pensions Bill 2007/8 is enacted. For ease of interpretation, we have included changes that relate to both sets of legislation in the sections that they relate to. We use a box format to keep them separate and easily distinguishable from the description of the pensions system that is in operation today.

This document is intended to provide a description of the UK pensions system for the purposes of considering pensions policy. It should not be used to make individual pensions decisions.

To explain the UK system, this report uses a multi-tier framework. As it stands today, the UK pensions system has three tiers:

- **Tier 1** is provided by the state and consists of a basic level of pension provision to which everyone either contributes or has access, providing a minimum level of retirement income.
- **Tier 2** is also provided by the state and aims to provide further pension that is more closely related to employees' earnings levels. Tier 2 has less redistribution (from rich to poor) than in the Tier 1. Tier 1 and Tier 2 operate on an unfunded 'pay-as-you-go' contributory basis, through the National Insurance (NI) system.
- **Tier 3** is private pensions provision, namely all those voluntary pension arrangements that are not directly funded by the state. Private pension contributions, from the employer and/or the individual, fund designated pensions for the individual. The primary aim of private pensions is to redistribute income across an

¹ DWP (2006) Security in retirement: towards a new pensions system and DWP (2006) Personal Accounts: a new way to save

individual's lifetime, and not to redistribute income from higher-income to lower-income people.

Chart 1 illustrates the three-tier UK pensions system as it stands today. Although means-tested benefits span across the three tiers, they are covered in the *First tier provision* section of this report.

Chart 1

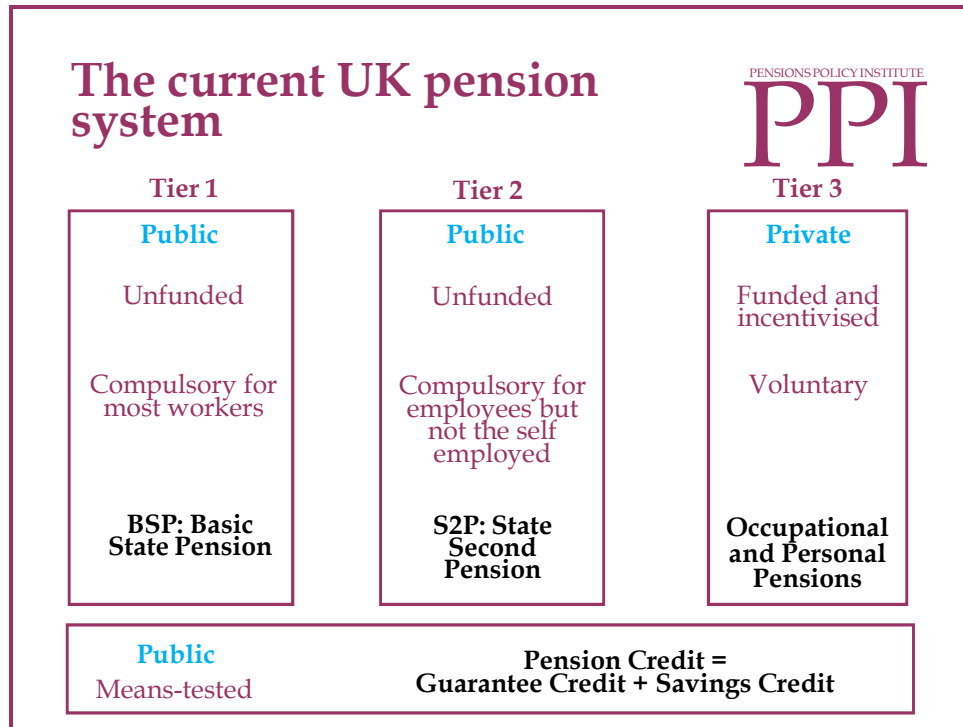
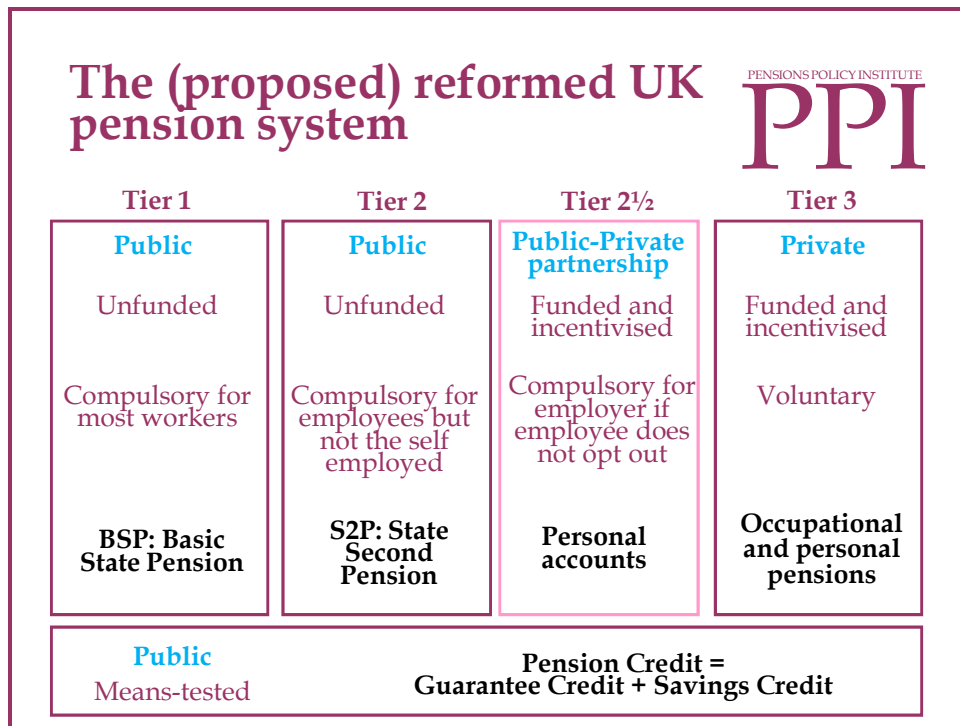


Chart 2 illustrates the changes likely to come into place under the proposed pension reforms. It includes an additional tier:

- **Tier 2½** will be a public-private partnership of individualised pension provision. This will operate similarly to Tier 3, private provision, but will be funded through employee, employer and Government contributions.

Although the new tier is a combination of private and public provision, the section describing the reforms has been included in the *Third tier provision* section of this report.

Chart 2



First tier provision

The first tier of pension provision is provided by the state and consists of a basic level of pension provision to which everyone either contributes or has access, providing a minimum level of retirement income. Included are:

- The Basic State Pension
- The Pension Credit

The first tier operates on a 'pay-as-you-go' basis, through National Insurance (NI) and general taxation. NI contributions levied on workers' earnings are used to pay the Basic State Pension. Pension Credit is funded through general taxation.

Pensioners receive other benefits, mainly funded through general taxation that could be considered as part of the first tier provision:

- Housing Benefit
- Council Tax Benefit
- Other (near) universal benefits

The **Basic State Pension (BSP)** is a contributory pension in the sense that the final amount of BSP paid to an individual depends on the number of contributions made before reaching SPA. The contribution rules for BSP are complex, and there are a number of ways in which contributions can be made or credited. There are further rules for married couples, people with incomplete contribution records and older pensioners. As it is possible to receive no BSP because of insufficient contributions, it is not a universal benefit.

BSP is payable from SPA - currently 65 for men and 60 for women. The SPA for women is due to increase gradually from 60 to 65, between 2010 and 2020. SPA will then increase in steps from 65 years to 68 years for both men and women between 2024 and 2046. Claiming the benefit can be deferred until after state pension age for an enhancement to the ultimate pension².

BSP is a redistributive, flat-rate pension. Subject to having made the same number of contributions, individuals will receive the same level of benefit, irrespective of the size of the contributions. An individual with a complete contribution record will receive a full BSP of £90.70 per week from April 2008³.

² See PPI Briefing Note Number 4 *Deferring State Pension* and Briefing Note Number 19 *The gain from deferring state pensions* for a discussion of deferring state pension

³ A married couple with one partner having a complete contribution record will receive a minimum of £145.05 per week. If both have a complete record they will both receive £90.70 per week.

Between 1974 and 1979 BSP was increased annually by the greater of the increase in National Average Earnings (NAE) or the increase in the Retail Prices Index (RPI). Since 1979, annual increases have generally been linked to RPI⁴. The net effect of past uprating has been that, although the value of the full BSP has increased in price terms since the 1970s, it has reduced relative to average earnings from 24% of NAE in 1974 to an estimated 16% of NAE in 2008⁵.

In addition, there are a number of means-tested benefits that pensioners may be eligible for depending on their circumstances.

The **Pension Credit (PC)** has two components: the Guarantee Credit, currently payable from age 60 and the Savings Credit, payable from age 65⁶.

The **Guarantee Credit (GC)** replaced Minimum Income Guarantee (MIG) in October 2003. The Guarantee Credit is almost identical to the MIG, the only difference being a more generous treatment of savings.

The GC is the main means-tested benefit for those aged 60 and above. As the name suggests, it is a benefit paid if other means do not reach a certain level. If claimed, it provides a safety-net minimum level of income. GC is paid to a 'benefit unit', that is a single person or a couple, if income from other sources is below the guaranteed level, provided any hours worked and savings held are below specified limits.

GC is redistributive. It is paid for from current taxes, which increase with an individual's income, while payments are only made to those on low incomes.

GC provides a minimum income of £124.05 per week from April 2008 for a single person and £189.35 per week for a couple. GC entitlement can be higher for disabled people, people with caring responsibilities or people with a mortgage.

Because GC is means-tested, the benefit has to be claimed. Official estimates show that in 2005/6, between 19% and 31% of households who were eligible for the GC component of Pension Credit did not take up their benefit⁷.

⁴ Since 2004 BSP has been increased by the higher of 2.5% or the RPI

⁵ PPI estimate; also see Department for Work and Pensions (DWP) (2006) *Abstract of Statistics 2005 Section 5 - Rates of Benefit* www.dwp.gov.uk/asd/asd1/abstract/Abstract2005.pdf and Office for National Statistics (ONS) (2006) *Annual Survey of Hours and Earnings 2006* www.statistics.gov.uk/downloads/theme_labour/ASHE_2006/2006_all_employees.pdf

⁶ The government has proposed that, from 2010, the minimum age for receiving the Guaranteed Credit element of PC will increase in line with increases in SPA for women, reaching 65 in 2020

⁷ This includes people that are eligible for the Guarantee Credit element only and people eligible for both the Guarantee Credit and Savings Credit elements. Department for Work and Pensions (DWP) (2007), *Income Related Benefits Estimates of Take-up in 2005-06*, www.dwp.gov.uk/asd/irb.asp

The **Savings Credit** aims to ensure that those who have made some private provision for retirement will be better off than those who have made no provision.

The maximum amount payable under Savings Credit is £19.71 per week for a single person and £26.13 per week for a couple. For every £1 of income received⁸ that is above the level of the Savings Credit threshold (£91.20 for single pensioners and £145.80 for couples, in 2008/9) but below the level of the Guarantee Credit, the Savings Credit pays an additional benefit of 60p. The credit is then 'tapered down' for additional income above the Guaranteed Credit level.

Guarantee Credit (and its predecessor, Minimum Income Guarantee) was increased in line with increases in NAE for the whole of the last parliament⁹. As a result of the changes to BSP indexation in the Pensions Act 2007, the Government has now committed to uprate the standard minimum guarantee in line with earnings in the long-term, and it is expected to continue as earnings-linked in the intervening years¹⁰. Guarantee Credit plus the average Savings Credit provides an income of around 24% of NAE¹¹.

Housing Benefit and Council Tax Benefit are means-tested benefits available to pensioners and to people under state pension age. Although they are not part of the first tier of pension provision in the UK, they are included here because they are nevertheless important benefits for many older people.

Housing Benefit (HB) is paid to people on low incomes who rent their home. It is designed to help with housing costs, including rent and some accommodation-related service charges. It is paid to renters who claim the benefit once they have been assessed as being eligible; around one-fifth of pensioner households are eligible for HB.

Not everybody that is eligible claims Housing Benefit. Official estimates show that, in 2005/6, between 11% and 16% of pensioner households who were eligible did not take up their benefit¹².

Council Tax Benefit (CTB) is a rebate scheme to provide help with up to 100% of an individual's council tax. Around half of pensioner households are entitled to CTB.

⁸ From ongoing employment, SERPS, Graduated Retirement Benefit, occupational schemes, personal pensions and assumed income from capital savings

⁹ Between May 2001 and May 2005

¹⁰ For example, published Government expenditure projections assume continued earnings-linking

¹¹ PPI calculation. The Guarantee Credit level in 2007/8 was £119.05, plus the average amount received in Savings Credit in May 2007 was £13.36 (for people not also eligible for the Guarantee Credit component). This adds up to £132.41, which is 24% of NAE in 2007/8.

¹² Department for Work and Pensions (DWP) (2007), *Income Related Benefits Estimates of Take-up in 2005-06*, www.dwp.gov.uk/asd/irb.asp

According to official estimates, take-up of CTB is relatively low; in 2005/6 between 40% and 46% of pensioner households who were eligible did not take up their benefit¹³.

Pensioners receive other benefits that could be considered as part of the first tier of provision:

- Benefits individually assessed for specific purposes (for example, Attendance Allowance)
- (Near) Universal benefits for all or most people at a certain age (for example, free TV licenses, Winter Fuel Payments)
- Enhanced tax allowances compared to working-age people

Changes in the Pensions Act 2007

Provisions in the Act will gradually increase the SPA for both sexes to 68 by 2046. This will begin with a rise from 65 to 66 over a two-year period from 2024, followed by a subsequent rise to 67 over a two-year period from 2034 and finally to 68 over a two-year period from 2044.

The Act links Basic State Pension and Guarantee Credit indexation to National Average Earnings, starting from some time after 2012 and before the end of the next Parliament. It also makes it easier for people to build up credits for BSP. This is done by reducing the number of contributory years needed to be entitled to the full BSP and by introducing a more generous system of credits for those with caring responsibilities.

¹³ Department for Work and Pensions (DWP) (2007), *Income Related Benefits Estimates of Take-up in 2005-06*, www.dwp.gov.uk/asd/irb.asp

Second tier provision

The UK's second tier of state pension provision operates on an unfunded 'pay-as-you-go' contributory basis, through the National Insurance (NI) system. Benefits are payable from SPA, and can be deferred in the same way as Basic State Pension. The self-employed are currently excluded from second tier provision.

The original aim of the second tier was to provide further pension income to employees that more closely related to their earnings level than the first tier. Contributions are made in proportion to earnings (in a band between minimum and maximum limits). Benefits reflect these contributions, so there is less redistribution (from rich to poor) than in the first tier.

Second tier provision in the UK has existed in three different schemes since 1961:

- Graduated Retirement Benefit (GRB: 1961 to 1975)
- State Earnings Related Pension Scheme (SERPS: 1978 to 2002)
- State Second Pension (S2P: from April 2002)

Pensioners today still receive small amounts of benefit from accrued rights to the **Graduated Retirement Benefit (GRB)**. The maximum weekly benefit amount payable in 2008/9 is £9.44 for men and £7.91 for women¹⁴.

The **State Earnings-Related Pension Scheme (SERPS)** is much more significant for current pensioners. The maximum benefit that can be received per week by a single person is £151.10 (2008/9)¹⁵.

The original aim of SERPS was to provide a pension of 25% of band earnings¹⁶. Subsequent changes to SERPS have reduced the value of SERPS benefits.

State Second Pension (S2P) started in 2002 as a replacement for SERPS. Significant pensions under S2P have yet to start payment. The main aim of S2P is to target greater resources at the lower paid and some individuals who cannot work due to disability or caring responsibilities. It is therefore more redistributive than SERPS, and people working on low pay benefit more than they did under SERPS.

The pattern of accruing benefits under S2P is more complicated than in SERPS, being based on three earnings bands and three accrual rates, rather than one band and one accrual rate. For low earners, a flat-rate of S2P pension is guaranteed. Higher earners accrue an additional earnings-related

¹⁴ Excluding any amounts of widow's pension or increments for delayed commencement

¹⁵ PPI calculation. This is the maximum amount for someone reaching state pension age in 2008/9, and comprises £120.88 in SERPS and £30.22 in S2P.

¹⁶ Earnings between the Lower Earnings Limit and Upper Earnings Limit

benefit. Disabled people, and some individuals with caring responsibilities, are credited into the flat-rate part of S2P.

It is possible to replace some state second tier provision with private pension provision. This is known as **contracting-out**. For example, members of Defined Benefit pension schemes can choose to forego some S2P benefits, provided that they are a member of a scheme that is expected to pay benefits that are at least as valuable as the S2P benefits foregone. Individuals who contract out effectively pay lower NI contributions, and so do their employers, since they are considered to be saving the equivalent amount in the private pension scheme¹⁷. The reduction in the level of NI contributions is called the 'contracting-out' rebate.

The size of the rebate is now set every 5 years with advice from the Government Actuary, and can act as an incentive or disincentive to contract-out depending on whether the invested rebate is perceived to give more or less than the defined benefit under S2P.

Changes in the Pensions Act 2007

The Act will make the State Second Pension flat-rate in future. From around 2030, the amount of S2P accrual each year should be completely flat-rate but in the mean time, accruals will continue to be dependent to some extent on people's earnings. It will also extend the system of credits in S2P for people with caring responsibilities.

The Act provides for the abolition of contracting-out of the State Second Pension for Defined Contribution occupational and personal pensions schemes. The aim is to introduce this change in April 2012 or by the end of the next Parliament at the latest. It will still be possible for Defined Benefit schemes to be contracted-out.

¹⁷ The exception to this is with money purchase or Defined Contribution schemes, where the level of NI contribution remains unchanged, but the Government later pays a rebate into the scheme

Third tier provision

The third tier of pension provision is **private pensions**, namely all those voluntary pension arrangements that are not directly funded by the state. As with state provision, private pension provision is complicated. The legislative framework has been altered over time, and individuals can retire with a number of pensions from many different arrangements.

Private pension contributions, from the employer and/or the individual, fund designated pensions for the individual. The primary aim of private pensions is to redistribute income across an individual's lifetime, and not to redistribute income from higher-income to lower-income people.

Many private pension arrangements are **employer-sponsored**. The employer link may be very strong; for example, the employer funds and administers an occupational scheme (see page 64). The link may be loose; for example, the employer may only give access to the products of a pension provider. Most schemes are arranged through single employers, although there are few industry-wide arrangements.

Individuals can make their own private pension arrangements by buying **personal pensions**. There are several types of these, including stakeholder pensions and, confusingly, the distinct product called a personal pension. Each underlying product works on the money-purchase principle: that is, it takes money in through contributions, this is invested in a fund, and the accumulated value is then used to buy an annuity to provide income for the remainder of their life. Subject to limits, part of the fund may also be paid out as a tax-free lump-sum.

Individual contributions to private pensions obtain tax relief at least at an individual's highest marginal rate (within limits). The pension fund is accumulated in a tax-favoured environment. On receipt, the pension is taxed as earned income. Any contributions the employer makes to private pensions will be deducted from the company's profit and so reduce its corporation tax liability. The company also benefits from National Insurance relief.

Most employer-sponsored provision is through **occupational pension schemes**, set up and administered on behalf of an employer. Occupational pension schemes can be Defined Benefit (DB) or Defined Contribution (DC). There are also some hybrid schemes which have features of both DB and DC.

In **Defined Benefit** schemes, the benefit received upon retirement is set by a preconceived formula, and contributions are varied in order to ensure that this level is reached. This works on a pooled fund basis – all contributions are paid into a common fund, which is invested to provide

all retirement benefits. In the normal course of events the investment performance of the scheme assets has no or minimal impact on the benefits an individual receives. The better the investment performance the lower the contributions needed.

The benefit from DB schemes will usually be based on an individual's length of service and his or her earnings at, or close to, retirement. A scheme might typically promise a pension of 1/60th of final salary for each year of service or a 1/80th pension plus a tax-free lump-sum cash amount of 3/80^{ths} for each year of service.

Such schemes usually have a normal pension age of 60 or 65¹⁸, but a member can usually retire early with a reduction in accrued benefits. People leaving the scheme on changing employer can preserve their rights in the scheme until pension age, or transfer the accrued rights to another arrangement.

Defined Contribution occupational schemes operate under similar legislation to a defined benefit scheme. The difference is that, while a DB scheme promises a specific level of benefit, a DC scheme operates on the money-purchase basis with a specified rate of contributions.

Contributions are usually expressed as a percentage of salary or total earnings. The rate of contribution could be a flat-rate or could be tiered by age and/or length of service and/or seniority and/or level of earnings. Employers may make a base level of contribution for all employees and may also match any employee's additional contribution.

Currently, both DB and DC schemes can be used to contract-out of S2P, although the Government has taken powers to abolish contracting-out for DC schemes in the Pensions Act 2007. The aim is to introduce this change in April 2012 or by the end of the next Parliament at the latest.

The Finance Act 2004, which took effect from 6 April 2006, included a number of amendments designed to simplify the taxation of the UK private pension regime, effectively capturing all pensions under a single set of rules¹⁹. The amount by which an individual can benefit from tax advantages is controlled by two 'allowances': annual and lifetime. These allowances apply to each individual, and across all registered pension schemes that the individual uses for providing benefits, regardless of the time of joining²⁰. An individual can make contributions to any number of private pension schemes and receive tax relief on the amount saved in

¹⁸ See ONS (2007) *Occupational Pension Schemes Survey 2006* Table 3.23 www.gad.gov.uk/Publications/docs/Final%20Report%2016Jun2005.pdf

¹⁹ See Inland Revenue (IR) (2003) *Simplifying the taxation of pension: the Government's Proposals* and Her Majesty's Treasury (HMT) (2004) *Prudence for a purpose: A Britain of stability and strength*, Budget report www.hm-treasury.gov.uk/budget/budget_04/budget_report/bud_bud04_repindex.cfm

²⁰ Although exemptions to the lifetime allowance are available to protect existing rights

that year up to the annual allowance (AA), set for 2008/9 at the lower of 100% of annual salary or £235,000²¹. If the value of an individual's pension fund increases by more than this limit in one year, the excess will be taxed at the rate of 40%.

The Lifetime Allowance is applied when the individual begins to receive a benefit from his or her pension saving. If the value of the pension saving at this time is above the Lifetime Allowance (£1.65 million in 2008/9), an additional tax charge is applied.

Because of the different nature of operation of DB and DC schemes, they carry different risks and benefits to the employer and employee, and there is much debate on the best arrangement for different types of employee²².

To increase the security of Defined Benefit occupational pension schemes, the government has introduced a 'Pension Protection Fund', which became operational in April 2006. This will pay a minimum level of pension even if an employer becomes insolvent and the pension fund is underfunded²³.

If only the employer contributes to the pension scheme, a scheme is known as non-contributory. Both employer and employee make contributions to contributory schemes. Until April 2006, all occupational pension schemes offered the facility for employees to make **additional voluntary contributions (AVCs)**, either to accrue further benefits in the scheme or separately, in free-standing arrangements. Some companies may no longer offer AVCs following changes to pension rules in April 2006, as there are now more options for people to top up their company pension through other means²⁴.

Employers can make arrangements for their employees without providing a formal pension scheme. These usually involve giving access to grouped individual personal pensions.

Individual personal pensions were only available to individuals while they were self-employed, or were not members of an occupational pension scheme, until April 2001. Legislation introducing stakeholder pensions widened access further, and from April 2006, individual pension arrangements became open to everyone under age 75.

²¹ The annual allowance will increase each year by £10,000 until 2010 when it will be reviewed

²² See PPI Briefing Note Number 2 The shift from Defined Benefit to Defined Contribution

²³ See Pension Protection Fund www.pensionprotectionfund.org.uk/ and HM Government (2004) *Pensions Act 2004* www.opsi.gov.uk/acts/acts2004/20040035.htm

²⁴ Between April 2001 and April 2006 members of an occupational pension scheme earning less than £30,000 per annum had an alternative 'concurrency' option. This allowed them to contribute up to £3,600 per annum into a stakeholder or personal pension. The £30,000 limit applied to each employment. So for example, it was possible for someone with more than one employment to have a concurrent pension even if his or her total earnings were above £30,000.

Stakeholder pensions are a form of low-charge personal pension that must meet a number of Government standards. The main difference between these and other types of personal pension are that management charges in each year are limited by a maximum charge cap and providers are not permitted to charge exit penalties²⁵.

For people who join a stakeholder pension after 6 April 2005, the maximum fund management charge is 1.5% for the first 10 years, thereafter reducing to 1%. For stakeholder plans that were opened before this date, the previous maximum charge of 1% will continue to apply.

Personal pensions and stakeholder pensions can also accept transfer values from occupational pensions or other individual arrangements and contracting-out rebates.

The Finance Act 2004 raised the minimum age that people can withdraw their pension benefits from 50 to 55 on 6 April 2010. It also introduced the option of more flexible retirement – people can continue working while taking pension benefits – where the occupational scheme rules allow it.

When an individual opts to withdraw some of their pension saving, he or she can choose one or a combination of three options:

- Cash lump sum. Up to 25% of a pension fund can be taken as a tax-free lump sum (provided the scheme rules allow it). If an individual's entire pension fund is less than 1% of the lifetime allowance (£16,500 in 2008/9), it is possible to 'trivially commute' and take the whole fund as a lump sum, with 25% being tax-free.
- Income withdrawal or 'drawdown'.
- Annuity. An insurance product that pays an income from the date of purchase until the date of death²⁶.

If a person has not opted for an annuity by the time they reach age 75, they must begin withdrawing their pension benefits, either by purchasing an annuity or by the additional option of an alternatively secured pension (ASP). An ASP allows some of the pension to be withdrawn as an income, whilst the remaining sum continues to be invested for future income. However, the Government has indicated that ASPs are only intended for a small group of people who have a principled religious objection to buying an annuity²⁷.

From April 2007 new rules will aim to prevent some people from using ASPs to pass on tax-favoured funds on or before their death²⁸.

²⁵ See RN Third tier: Individual pension arrangements

²⁶ An annuity insures against an individual's money running out because he or she lives longer than expected

²⁷ FSA fact-sheet

www.money.madeclear.fsa.gov.uk/pdfs/income_withdrawal.pdf

²⁸ For more information on ASPs see Financial Services Authority or HMRC websites

Changes proposed in the Pensions Bill 2007/8

The DWP White Paper's, *Security in retirement: towards a new pensions system* and *Personal accounts: a new way to save*, set out the Government's proposals to encourage and enable private pension saving in the UK. It will do this by:

- Introducing a new pension saving scheme of low-cost, portable, individualised pension savings accounts from 2012, called personal accounts.
- Introducing auto-enrolment into private pension for all employees over 22 years of age and earning more than £5,035 (in 2006 earnings) a year, either into personal accounts or an equivalent employer-based pension scheme, with an option for employees to opt out.
- Setting a national minimum employer contribution of 3% of earnings between £5,035 and £33,540 (in 2006 earnings) a year for those employees who do not opt out.
- Setting a minimum overall level of contribution of 8% (made up of 4% from band earnings contributed by employees, matched by a compulsory 3% contribution of band earnings from the individual's employer and a minimum 1% contribution of band earnings from the Government, delivered through tax relief as per current rules²⁹) and encouraging additional contributions.

Many of the details of personal accounts are yet to be finalised. The Pensions Act 2007 established the Personal Accounts Delivery Authority (PADA) to provide advice to Government in preparation for the introduction of personal accounts. If enacted, the Pensions Bill 2007/8 would give the Delivery Authority executive powers and will establish the auto-enrolment policy and personal accounts.

²⁹ The tax relief may be higher for those people who pay higher-rate tax

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First tier: Eligibility for Basic State Pension

The Basic State Pension (BSP) is based on an individual's National Insurance (NI) contribution record. Any tax year in which they make, or are credited with, sufficient NI contributions is known as a qualifying year.

Employees make Class 1 contributions when their weekly earnings exceed the 'Primary Earnings Threshold' (PET) of £105 per week. If they earn less than the PET but more than the 'Lower Earnings Limit' (LEL) of £90 per week, then they do not make Class 1 contributions but are credited for the BSP¹. The self-employed make flat-rate Class 2 contributions of £2.30 per week². Class 3 voluntary contributions, of £8.10 per week, are paid by those who wish to protect their entitlement and have not paid enough Class 1 or Class 2 contributions.

The full rate of BSP, which from April 2008 is £90.70 per week for a single person, is payable to men with at least 44 qualifying years from a maximum of 49. For women born prior to 6 April 1950 the full rate is payable with at least 39 qualifying years from a maximum of 44. This changes as the state pension age for women increases, until for those born after 5 April 1955 the threshold is 44 years from a maximum of 49.

A proportionate benefit is payable if the number of qualifying years is less than that needed for the maximum. For example, a woman with a 30 year contribution record will receive BSP of £69.77 per week $((30/39) * £90.70)$ ³. However, if the number of qualifying years is less than 25% of the amount required for a maximum BSP then no BSP benefit is payable.

Home Responsibilities Protection (HRP) was introduced in 1978 and reduces the number of years of contribution required to secure a full BSP. Protection can be given for those complete tax years where an individual is caring for children or an older or a disabled person. If a woman⁴ cares for a child until age 16 the requirement for a maximum BSP would reduce from 39 qualifying years to 24.

HRP does not give complete protection as it cannot reduce the number of qualifying years required for a full BSP below 20 (22 for women from 2020).

¹ From April 2008; unless otherwise stated figures given relate to 2008/9

² Special Class 2 rates apply for fishermen and volunteer development workers. These are £2.95 and £4.50 respectively. The self-employed also make class 4 contributions, which are earnings-related but do not affect BSP entitlement.

³ Assuming no Home Responsibilities Protection is awarded

⁴ Although most recipients are women, HRP is unisex - it is available to the person to whom child benefit is payable

There are 19 activities that can credit someone into the Basic State Pension. Credit will be given if, for instance, an individual is entitled to Statutory Sick Pay or Statutory Maternity Pay, Jobs Seekers Allowance, Incapacity Benefit, Carer's Allowance, Severe Disablement Allowance, or if an individual is aged 16, 17 or 18, or for men aged 60 to 64⁵.

No qualifying years are earned and no HRP credit is earned if a married woman or widow is paying reduced-rate NI contributions⁶.

Changes in the Pensions Act 2007

Both men and women reaching State Pension Age (SPA) from 6 April 2010 will only need 30 qualifying years to be eligible for the full Basic State Pension. The Pensions Act also abolishes the 25% minimum contribution threshold, meaning that people reaching SPA after 6 April 2010 will receive a proportion of the full BSP for every contributing year.

For people reaching SPA after 6 April 2010, HRP *reductions* will be converted into positive *credits*. This means that instead of reducing the number of years needed to qualify for the BSP, certain caring responsibilities will constitute a contribution to qualifying years. The outcome for individuals is the same but the change simplifies the way entitlement is calculated.

From 2010, carers will receive *weekly* contribution credits if in that week they:

- are awarded child benefit; or
- are a foster parent for a child under the age of 12; or
- are engaged in caring within the meaning given in regulations (people caring for one sick or severely disabled person for 20 hours or more per week will qualify for credit, subject to an appropriate validation process).

This change will mean that in any year, individuals can combine *caring credits* with *NI contributions* to build up a qualifying year. From 2010, credits for people who are caring for children will be awarded until the youngest child reaches 12 years (down from 16 years), aligning the rules for Basic State Pension and State Second Pension (discussed in the next section).

⁵ For more information see House of Commons Hansard, 26 June 2006 Col 63W www.publications.parliament.uk/pa/cm200506/cmhansrd/vo060626/text/60626w0013.htm#06062622000050

⁶ Between 1948 and 1978 married women could elect to pay a reduced rate of NI contributions, known as the 'Married Women's Reduced Rate Election'. By electing to pay the reduced rate, women forfeited the right to a pension based on their own contributions and instead relied on their husband's contribution record. The wife would then receive a pension once the husband reached 65 at the rate of 60% of the husband's pension. The option to elect to pay the reduced rate ceased to be available in 1977. Entitlement to the option is lost if an individual is not working for more than 2 complete tax years. Alternatively, individuals can elect to recommence paying the full rate. PPI calculations based on data provided by DWP estimate that in 2003 around 60,000 women were still paying at the reduced rate (see Briefing Note 11, July 2004). This figure is likely to have reduced since 2003.

Example⁷

After 6 years of full-time education Mary starts work on her 22nd birthday. She works for 4 years then takes an 18-year break to care for her only child, before recommencing employment and working for 16 years until her 60th birthday.

Mary works for a total of 20 years, giving her 20 qualifying years (since no credit is ever given for contributions made in the tax year in which an individual reaches SPA).

Since HRP only applies for full tax years while the child is below age 16, Mary receives 15 years of HRP credit. In addition, she will have been credited with minimum contributions for the tax years in which she was 16, 17 and 18.

Mary is eligible for a BSP of 96% $((20 + 3) / 24^{\text{ths}})$ of the maximum. This amounts to £86.92 in 2008/9, since the number of qualifying years required for a full BSP is 24 (39 - 15).

Had Mary only worked 2 years then no BSP would be payable because the 25% rule would not be met.

Had there been no HRP Mary would have received only 59% $(23/39^{\text{ths}})$ of BSP, or £53.49 per week.

This example assumes Mary reaches state pension age before 2010, before the changes in the Pensions Act 2007 come into effect.

Sources

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⁷ Throughout this paper, examples relate to entitlement under current rules in the pension system. Changes outlined in the Pensions Act could alter individuals' future entitlements.

First tier: Categories of Basic State Pension

There are five categories of Basic State Pension (BSP) provided by the state:

- Category A is based on the individual's contributions
- Category B is based on a spouse's or civil partner's qualifying years
- Category C is non-contributory, and is payable to the widow of a man who was over 65 on 5 July 1948
- Category D is non-contributory and is payable to those over 80 satisfying certain residency conditions
- Age Addition is non-contributory and is payable to all recipients of state pensions aged 80 or above

Category A pension

This is contributory and is based on the individual's contribution history. Where an individual has an incomplete contribution record then the qualifying years of a *former* spouse (separated through either bereavement or divorce) can be substituted to provide a higher BSP.

Changes in the Pensions Act 2007

For people reaching state pension age before 6 April 2010, and for those claiming bereavement benefits, existing contribution conditions will continue to apply.

For those reaching state pension age from 6 April 2010, the number of years needed to qualify for a full category A pension is to be reduced from 44 years for a man and 39 years for a woman to 30 qualifying years for men and women alike. A person who has less than 30 qualifying years will be entitled to a proportion of the full BSP for each qualifying year they have built up.

The Pensions Act 2007 will also allow relevant parents and carers to build up entitlement to a category A pension through credits.

Parents or guardians (awarded child benefit for a child aged under 12), a registered foster parent or a carer providing care (for one or more severely disabled persons or caring for a child under 12) reaching SPA from 6 April 2010 will be able to build up credits towards a category A pension.

For those reaching SPA from 6 April 2010, each complete year (subject to a limit) of home responsibilities protection awarded under the existing rules of the scheme will be converted into a qualifying year for BSP.

Category B pension

This is contributory and is based solely on a spouse's or civil partner's qualifying years and earnings. Currently it is payable to married women, widows and widowers but from 6 April 2010 both men and women will be able to claim BSP based on their spouse's or partner's NI record if this is better than their own. At present, claimants can only receive category B pension if their spouse or civil partner has made a claim for category A pension.

Changes in the Pensions Act 2007

The Pensions Act 2007 removes the restrictions on entitlement, allowing claimants who have reached SPA after 6 April 2010 to claim category B pension even if their spouse has deferred their own category A claim. Changes will also allow the spouse or partner of a carer to build up entitlement to an associated category B pension.

As a result of other changes made by the Act, the extent to which people will be reliant on category B pensions derived from their spouse's or partner's contributions will be significantly reduced.

Married couples

If both husband and wife have a satisfactory NI contribution record then they will each receive a full BSP when they reach SPA. However if the wife is entitled to less than 60% of the full BSP and she is over state pension age, she may be able to claim a composite category A and category B pension based on her husband's contribution record, which could increase her pension to 60% of the full rate.

If the wife is under state pension age and the husband is over state pension age and is claiming the BSP, then the husband may be eligible for an adult dependency increase to his state pension in respect of the wife, equal to 60% of the full BSP.

Changes in the Pensions Act 2007

The Act abolishes adult dependency increases for dependants under state pension age from 6 April 2010. Provisions will be made to protect entitlements up to 5 April 2020.

Example

George and Elizabeth are a married couple who are both over state pension age. George has a full NI contribution record and receives the full BSP of £90.70 per week (category A). In comparison Elizabeth has an incomplete record and based on her contributions would only receive £30.00 per week (category A). However she can claim an additional £24.35 per week (category B) based on George's record giving a total weekly income of £145.05 for the couple.

If George had reached 65 and Elizabeth had not reached 60 then so long as Elizabeth was earning less than £60.50¹ per week then he could claim a dependent adult's addition and receive the full £145.05. If Elizabeth was earning over £60.50 per week then George could only claim £90.70.

Once Elizabeth reaches 60 the full £145.05 would be payable to the couple even if she continues to work. From that date £90.70 would be payable to George and £54.35 would be payable to Elizabeth (£145.05 - £90.70 = £54.35).

Category C pension

Category C pensions are now obsolete and are being gradually phased out. These are payable at the rate of 60% of the full BSP to people over SPA on 5 July 1948 or to the widow of a man who was over 65 in July 1948. Approximately 60 category C pensions were still in payment as of November 2007².

Category D pension

A non-contributory pension, equivalent to the dependent adult's addition, is awarded to those who:

- are aged 80 or above, and
- have been resident in the UK for at least 10 years in the previous 20 and
- receive either no BSP or less than the dependent adult's addition.

This is sometimes called the 'Over 80 Pension' and in 2008/9 it amounts to £54.35 per week.

Age addition

An age addition of 25p is payable to all recipients of BSP aged 80 or over. When it was introduced in 1971 the full BSP was £6.00 – effectively a 4.2% enhancement. Subsequently, the age addition has not been increased, and so is now only a 0.3% enhancement.

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¹ This figure is set by the Government each year and applies only to couples who live together. For more information see form GL 23 *Social Security Benefit Rates*.

² PPI estimate based on DWP statistics available through tabulation tool

First tier: State pension age

The SPA is currently 65 for men and 60 for women. It will increase for women born on or after 6 April 1950 to bring it in line with the age for men. For those born on or after 6 April 1955 the SPA will be 65. Women born in the intermediate period will have a SPA that is approximately 1 extra month for each month (or part month) they were born after 6 April 1950.

During this period all people become eligible to receive state pensions on the 6th of the relevant month. Effectively those born just after the 6th become eligible at an older age than those born on the 5th of the next month.

Table 1: State Pension Age for women in transition period

Date of Birth	State Pension Date	State Pension Age
6 April 1950 – 5 May 1950	6 May 2010	60 yrs 1 mth – 60 yrs 0 mths
6 May 1950 – 5 June 1950	6 July 2010	60 yrs 2 mths – 60 yrs 1 mth
6 June 1950 – 5 July 1950	6 Sept 2010	60 yrs 3 mths – 60 yrs 2 mths
6 July 1950 – 5 Aug 1950	6 Nov 2010	60 yrs 4 mths – 60 yrs 3 mths
6 Aug 1950 – 5 Sept 1950	6 Jan 2011	60 yrs 5 mths – 60 yrs 4 mths
6 Sept 1950 – 5 Oct 1950	6 March 2011	60 yrs 6 mths – 60 yrs 5 mths
6 March 1955 – 5 April 1955	6 March 2020	65 yrs – 64 yrs 11 mths
6 April 1955	6 April 2020	65 yrs

Changes in the Pensions Act 2007

SPA will gradually increase for men and women to 68 years by 2050. The SPA increase will be staircased – that is, SPA will increase by 1 year each decade between 2020 and 2050, and changes will be phased in over a two year period in the middle of each decade. As such,

- People born between 6 April 1959 and 5 April 1960 will reach SPA between 65 years and 66 years of age depending on when in that period they were born, ie some will reach SPA at 65 years and 2 months, for example.
- People born between 6 April 1960 and 5 April 1968 will all reach SPA at 66 years.
- People born between 6 April 1968 and 5 April 1969 will reach SPA between 66 years and 67 years of age depending on when in that period they were born.
- People born between 6 April 1969 and 5 April 1977 will all reach SPA at 67 years. And so on.

Staircased increase of State Pension Age for men and women

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Sources

Department for Work and Pensions (DWP) (2005) *A Guide to State Pensions -NP46 Section - Revised pension ages for women*
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First tier: Deferral of state pensions

Individuals can choose to defer the commencement of their BSP in return for an enhanced pension, through the award of increments or as a one-off lump sum¹.

Until April 2005, the basis for determining increments was that each pension would be increased by 1% for each 7 weeks of deferral. From April 2005 the terms have been improved so the pension is increased by 1% for each 5 weeks of deferral.

Until April 2005 state pension could not be deferred past age 70. From April 2005 this restriction has been removed.

Increments can be earned after payments have started if recipients request that the Department for Work and Pensions cease payments. Increments will be earned at the same rate.

Similar rules are in place for other state pensions including the Graduated Retirement Benefit, SERPS and S2P (discussed in later sections). However, an individual must defer all state pension benefits – they cannot elect for instance to defer BSP but start receiving SERPS.

While benefit is being deferred, the amount not claimed is still counted as income for Pension Credit and other means-tested benefits.

Benefit that has been deferred for 12 consecutive months from April 2005 can be taken as a one-off lump sum payment, rather than as an increase in future pension payments. The deferred benefit will accrue interest at 2% above the Bank of England Base Interest Rate, and the whole of the resulting lump sum will be taxable at the marginal rate of tax paid by the pensioner on his or her other income². Because of the high interest rate available, there can be a financial gain from deferring and taking a lump sum. The actual gain is not the full value of the lump sum (as it can be claimed and invested instead) but the value of the extra interest over and above what could be gained from claiming the pension and investing it.

Note: The expected financial gain from lump sum deferral can change from year to year and will depend on the difference between the Bank of England base rate and market rates of return, for example, from saving in a bank account. The expected gains in Table 2 are relatively small compared to the expected gains shown in previous versions of *The Pensions Primer*. This is because, due to economic conditions at the time of

¹ Increments can also be awarded if payment is delayed for other reasons, such as a delay in returning the forms, or the Department for Work and Pensions not being aware of a change of address. Whatever the reason for the delay, individuals can only receive a 'back-payment' of up to 3 months of the missed payments.

² Even if some of the lump sum would normally have fallen in a higher tax band

printing, there was a large gap between the base rate and market rates that offset the gains from the 2% accrual rate of interest offered to people who deferred.

Table 2: Likely gain from lump sum deferral option before tax (2008/9 prices)³

State pension £ per week (average for new pensioners) ⁴	Years deferred	Lump Sum from Government (current base rate 5.0% plus 2%)	Lump sum from taking the pension and saving it (at, say, 6.41%)	Likely gain
£78 (women aged 60-64)	5	£22,450	£22,130	£320
£112 (men aged 65-69)	1	£5,885	£5,870	£15
	2	£12,030	£11,960	£70
	5	£32,220	£31,760	£460
	10	£74,180	£72,060	£2,120

If marginal tax rates change, for example, someone moves from the higher rate to the basic rate tax band after deferral, there can be a larger gain.

Table 3: Possible tax-advantaged gain from deferral⁵ - higher to basic rate (2008/9 prices)

State pension £ per week (average for new pensioners)	Years deferred	Lump Sum from Government (current base rate 5.0% plus 2%), tax paid at basic rate	Lump sum from taking the pension and saving it (at say 6.41%), tax paid at higher rate	Possible gain
£78 (women aged 60-64)	5	£17,960	£12,475	£5,485
£112 (men aged 65-69)	1	£4,710	£3,475	£1,235
	2	£9,620	£7,000	£2,620
	5	£25,775	£17,905	£7,870
	10	£59,345	£38,155	£21,190

If a pensioner dies before the pension is claimed, the lump sum can be inherited by a partner. All of the lump sum arising from deferred Basic State Pension can be inherited, but only 50% of the lump sum arising from other state pensions can be inherited⁶. The inherited lump sum can only be claimed once the widow(er)⁷ claims her or his state pension.

Those who are already receiving a state pension by April 2005 have the option of cancelling their claim to build up extra entitlement or, after 12 months of deferment, to claim a lump sum. If someone is already

³ See PPI (2005) Briefing Note Number 19 www.pensionspolicyinstitute.org.uk

⁴ DWP (2007) Tabulation Tool May 2007

⁵ See PPI (2005) Briefing Note Number 19 www.pensionspolicyinstitute.org.uk. This table assumes that the entire lump sum is subject to tax at the marginal rate of tax paid on other income (so that the lump sum itself does not take someone into a higher tax band). This is the Government's intention as set out in the Finance Act 2005.

⁶ This relates to the Second State Pension. The rules regarding inheritance of SERPS are more complicated. The amount of SERPS pension someone can pass on if they die depends on their date of birth, the year they reach state pension age and their sex. Spouses or civil partners may be able to inherit between 50% and 100% of the SERPS pension.

⁷ Until April 2010 a widower will not be able to inherit a lump sum unless he was also over state pension age when his wife died

deferring their pension, they will receive an increase based on the current rate for the period up to 6th April 2005. They will then become eligible for the new rate or, if they continue to defer for a further 12 months, a lump sum.

Deferred pension that is paid as an enhanced pension is counted in full for Pension Credit. But the lump sum is excluded from Pension Credit calculations⁸, making this option more attractive to people likely to be entitled to Pension Credit.

Prior to 1989 individuals had to cease receiving earnings from employment before being eligible to claim their state pensions. Although the deferral was not voluntary, increments were still earned over the intervening period. There is now nothing to stop individuals taking state pensions while earning.

Sources

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⁸ See The Pension Service (2006) *State Pension Deferral*

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First tier: Impact of indexation of BSP

The rules for increasing BSP have undergone many changes over the last four decades.

- Before 1974 BSP was increased on an ad-hoc basis. For instance in November 1969 it was increased from £4.50 to £5.00 per week and then not increased until September 1971 when it was increased to £6.00 per week.
- From 1974 to 1979 it was increased each year by the greater of the increase in National Average Earnings (NAE) and the Retail Prices Index (RPI).
- From 1979 to 2000 it was increased by the increase in RPI – from 1979 to 1983 on a forecasted basis and from 1983 on a historic basis.

The Social Security Administration Act of 1992 first introduced statutory uprating. This means that since 1992, BSP is increased each April by the increase in the RPI for the 12 months to the previous September.

In 2001, BSP was increased by £5.00 per week, in 2002 by £3.00 and in 2003 by £1.95 - more than the statutory minimum - in response to criticism of the 75p increase awarded in 2000.

In November 2001 it was announced that from 2003 increases would be a minimum of £100 per annum for single pensioners and £160 for married couples. The actual annual increases in the BSP in 2004 were £111.80 and £179.40 for single pensioners and for married couples respectively.

Although the statutory uprating is to increase BSP annually in line with the RPI, in recent years the BSP has been increased by the greater of 2.5% or the RPI. The net effect is that although the value of the BSP has increased in real terms, when compared to NAE its value has gradually eroded since 1979. Under current policy BSP may continue to erode relative to NAE until at least 2012¹.

Changes in the Pensions Act 2007

In future the BSP will be uprated annually in line with earnings rather than prices. The Government aims to make this change from 2012, subject to affordability and the fiscal position, but at any event by the end of the next Parliament at the latest. The Secretary of State for Work and Pensions will determine how annual average earnings increases are calculated.

¹ Assumptions – RPI increases each year by 2.5%. NAE increases each year by 2% above the RPI.

Table 4: Historical uprating of BSP in relation to National Average Earnings

From	BSP - Weekly Amount	Adjusted to April 2008 prices	Weekly National Average Earnings	BSP as a percentage of NAE
October 1972	£6.75	£64.79	£32.00	21.1%
July 1974	£10.00	£76.95	£41.70	24.0%
November 1977	£17.50	£78.84	£70.20	24.9%
November 1979	£23.30	£82.76	£89.60	26.0%
November 1982	£32.85	£85.04	£136.50	24.1%
April 1987	£39.50	£83.04	£198.90	19.9%
April 1992	£54.15	£83.49	£304.60	17.8%
April 2000	£67.50	£84.92	£425.10	15.9%
April 2001	£72.50	£89.63	£449.70	16.1%
April 2002	£75.50	£91.96	£472.10	16.0%
April 2003	£77.45	£91.47	£487.10	15.9%
April 2004	£79.60	£91.73	£498.20	16.0%
April 2005	£82.05	£91.64	£516.40	15.9%
April 2006	£84.25	£91.75	£534.90	15.8%
April 2007	£87.30	£90.96	£549.80	15.9%

Table 5: Projected uprating of BSP under the current and reformed systems

Tax Year	Weekly National Average Earnings ² (Projected)	Current system (increasing with prices)		Reformed system (increasing with earnings from 2012)	
		BSP - Weekly Amount (Projected)	Projected BSP as a percentage of NAE	BSP - Weekly Amount (Projected)	Projected BSP as a percentage of NAE
April 2008	£575	£90.70	16%	£90.70	16%
April 2010	£628	£95.25	15%	£95.25	15%
April 2015	£785	£107.80	14%	£116.70	15%
April 2020	£980	£122.00	12%	£145.75	15%
April 2025	£1,225	£138.05	11%	£182.15	15%
April 2030	£1,530	£156.20	10%	£227.50	15%
April 2035	£1,911	£176.70	9%	£284.15	15%

Sources

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² Earnings are assumed to increase by 2% a year above RPI inflation of 2.5%

First tier: The Guarantee Credit

The Guarantee Credit replaced the Minimum Income Guarantee (MIG) in October 2003. Guarantee Credit (GC) is the name used for income support for the over 60s. It is payable from age 60 as a tax-free means-tested benefit – it is only paid to those with low incomes and with low savings¹.

Its effect is redistributive – the benefit is paid for from taxes that are related to income and only paid to those on low income. In 2008/9 it will guarantee single pensioners a minimum income of £124.05 per week and couples a minimum income of £189.35 per week.

An individual or couple² is eligible for GC if they:

- are aged 60 or over (either person in the case of a couple)
- on a low income, and
- working less than 16 hours a week (and any partner working less than 24 hours a week), and

GC can be higher where:

- an individual (or an individual within a couple) is disabled and living on their own or living with another disabled person, or
- an individual (or an individual within a couple) is a carer getting Carer's Allowance, or
- where there are housing costs not fully covered by Housing Benefit

Lower levels of benefit are paid if pensioners have savings of more than £6,000. GC is currently reduced by £1.00 per week for each £500 (or part thereof) in excess of £6,000³. This is more generous than under the MIG⁴.

Future Government Policy

The Government has announced that it intends to continue uprating the Guarantee Credit level by earnings in future.

¹ Savings consist of liquid assets, such as cash, building society and bank accounts, national savings, unit trusts and shares. It does not include the value of the home.

² Married or cohabiting with someone of the opposite sex

³ Or £10,000 for people living in care homes

⁴ Under the previous legislation the MIG was reduced by £1.00 per week for each £250 in excess of £6,000.

Example

The table below shows the impact of various levels of accrued savings for a single person receiving only the BSP of £90.70.

Table 6: Interaction of accrued savings with Pension Credit

Savings	Previous Basis			Current Basis			Weekly Gain
	Assumed Savings Income	MIG Benefit	Total Weekly BSP +MIG	Assumed Savings Income	GC Benefit	Total Weekly BSP + GC	
£0	£0.00	£33.35	£124.05	£0.00	£33.35	£124.05	£0.00
£6,000	£0.00	£33.35	£124.05	£0.00	£33.35	£124.05	£0.00
£8,000	£8.00	£25.35	£116.05	£4.00	£29.35	£120.05	£4.00
£10,000	£16.00	£17.35	£108.05	£8.00	£25.35	£116.05	£8.00
£12,000	£24.00	N/A	£90.70	£12.00	£21.35	£112.05	£21.35
£14,000	£32.00	N/A	£90.70	£16.00	£17.35	£108.05	£17.35
£16,000	£40.00	N/A	£90.70	£20.00	£13.35	£104.05	£13.35
£18,000	£48.00	N/A	£90.70	£24.00	£9.35	£100.05	£9.35
£20,000	£56.00	N/A	£90.70	£28.00	£5.35	£96.05	£5.35

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First tier: The Savings Credit

The Pension Credit replaced the MIG in October 2003. The Pension Credit (PC) consists of two parts – the Guarantee Credit (GC) which is similar to the MIG, and the Savings Credit (SC).

SC attempts to ensure that anyone who has made some non-state provision for retirement will be better off than those who have made no provision.

However, those who do not have a full BSP will not receive credit for all of their savings. While the GC is payable from age 60, the savings credit is only payable to pensioners from age 65.

SC pays a tax-free allowance of 60p per £1 for any income between the SC threshold and the GC threshold. This includes some income from ongoing employment, SERPS, Graduated Retirement Benefit, some employer-sponsored pension schemes, personal pensions and notional income from savings. The amount of SC received then reduces by 40p for every £1 of income above the GC threshold. The maximum SC that can be received in 2008/9 is £19.71 for single pensioners and £26.13 for couples. For single pensioners, SC is no longer payable when income exceeds £173¹.

When SC was introduced in 2003, the SC threshold was set equal to the BSP. The Pensions Act 2007 has uncoupled the two and the SC threshold is now expected to increase more quickly than the BSP. This change became effective from April 2008. For 2008/9, the SC threshold is set at £91.20 per week for single pensioners, compared to the BSP level of £90.70 per week.

¹ For pensioner couples the SC threshold is £145.05 per week and GC is £189.35 per week (2008/9). The maximum SC is therefore £26.13 per week and Savings Credit ceases when income reaches £255 per week. Income limits for single and pensioner couples could be higher if they qualify for a higher level of GC through severe disability, caring or housing costs.

Table 7: Interaction of income with GC and SC in the 2008/9 Tax Year

Single Pensioner				Pensioner Couple			
Weekly income	Guarantee Credit	Savings Credit	Total income	Weekly income	Guarantee Credit	Savings Credit	Total income
£50.00	£74.05	£0.00	£124.05	£110.00	£79.35	£0.00	£189.35
£60.00	£64.05	£0.00	£124.05	£120.00	£69.35	£0.00	£189.35
£70.00	£54.05	£0.00	£124.05	£130.00	£59.35	£0.00	£189.35
£80.00	£44.05	£0.00	£124.05	£140.00	£49.35	£0.00	£189.35
£90.00	£34.05	£0.00	£124.05	£150.00	£39.35	£2.52	£191.87
£100.00	£24.05	£5.28	£129.33	£160.00	£29.35	£8.52	£197.87
£110.00	£14.05	£11.28	£135.33	£170.00	£19.35	£14.52	£203.87
£120.00	£4.05	£17.28	£141.33	£180.00	£9.35	£20.52	£209.87
£130.00	£0.00	£17.33	£147.33	£190.00	£0.00	£25.87	£215.87
£140.00	£0.00	£13.33	£153.33	£200.00	£0.00	£21.87	£221.87
£150.00	£0.00	£9.33	£159.33	£210.00	£0.00	£17.87	£227.87
£160.00	£0.00	£5.33	£165.33	£220.00	£0.00	£13.87	£233.87
£170.00	£0.00	£1.33	£171.33	£230.00	£0.00	£9.87	£239.87
£180.00	£0.00	£0.00	£180.00	£240.00	£0.00	£5.87	£245.87
£190.00	£0.00	£0.00	£190.00	£250.00	£0.00	£1.87	£251.87
£200.00	£0.00	£0.00	£200.00	£260.00	£0.00	£0.00	£260.00

Example

Dolly is entitled to a BSP of £80.70 per week - £10 below the maximum entitlement for a single person. She also receives an occupational pension of £30.00 per week giving a total of £110.70. She will be entitled to a guaranteed element of £13.35 from age 60 (to increase her income to the Guarantee Credit level of £124.05 per week) and from 65 will also receive a savings credit of £11.70 per week i.e. 60% of the excess above £91.20. If Dolly was receiving a full BSP, she would receive £17.70 per week savings credit.

Future Government Policy

The Government has announced that it intends to continue uprating the Savings Credit threshold by earnings from April 2008 until April 2014. The maximum amount of Savings Credit will increase with prices from April 2015. This implies that the SC threshold is expected to increase more quickly than earnings from 2015, in order to gradually close the gap with the Guarantee Credit level (in earnings terms).

Sources

The Pension Service (TPS) (2006) *Pension Credit*
www.pensions.gov.uk/pensioncredit/home.asp
 Department for Work and Pensions (DWP) (June 2002) *Press Release: Pension Credit Bill gets Royal Assent*
www.gnn.gov.uk/content/detail.asp?ReleaseID=33216&NewsAreaID=2&NavigatedFromSearch=True

First Tier: Housing Benefit

Housing Benefit (HB) is a means-tested benefit that is designed to help individuals who rent accommodation pay for their rent. It is paid to single people or couples based on their income. This includes some income from employment, state and private pensions, notional income from capital and Savings Credit.

The maximum amount of benefit is an amount equal to a person's (or couple's) share of the household's rent and is paid if claimants are also eligible for Guarantee Credit. In practice, the amount of rent that can be taken into account in the calculation of HB will be restricted, if the amount of rent paid by the household is considered to be excessive².

The amount of rent that is actually taken into account in the calculation of HB, after these restrictions have been applied, is called 'eligible rent'.

Housing Benefit is reduced once income reaches a personal allowance of £143.80 per week in 2008/9³. This is intentionally set to equal the Guarantee Credit level (£124.05 per week) plus the maximum amount of Savings Credit (£19.71 per week). As Savings Credit is taken into account for HB, this means that HB is withdrawn once an individual is no longer eligible for the Guarantee Credit.

If the claimant's income is above the personal allowance level, then the amount of Housing Benefit is reduced at the rate of 65p for every £1 of additional income. No benefit is payable if claimants have capital of more than £16,000, unless they are also eligible for Guarantee Credit. Higher personal allowances can apply for individuals who are eligible for premiums for Pension Credit.

The Welfare Reform Act 2007 legislated for the roll-out of Local Housing Allowance (LHA) across the private rented sector from 7 April 2008. LHA is similar to Housing Benefit in that it is a means-tested benefit that aims to help people on modest incomes pay for their rent. However, it differs in how the amount of benefit is determined and in the mechanisms by which the benefit is delivered.

The maximum amount of Housing Benefit payable is the amount of rent that a particular person (or couple) pays, subject to a series of restrictions. LHA would give a claimant an allowance, based on market rents in the particular locality and on housing needs. Individuals can decide to live in more expensive accommodation than the allowance would cover, in

² For example, if the contractual rent is significantly above the market level. The size of the accommodation relative to the needs of the tenant may also be considered and rents will also be compared to 'local reference rates', which are calculated as the midpoint of a range of rents for properties of the same size in the locality.

³ £215.50 per week for couples

which case they would have to find an amount to cover the difference, or live in cheaper accommodation, in which case they could pocket the extra amount received from the allowance.

LHA aims to pay the benefit more often to the individuals involved, rather than straight to the landlord as can be the case for some Housing Benefit claims, as a way of fostering greater personal responsibility and money management skills.

Example

Susan is a 60 year old single woman who does not own her own home. She rents an apartment which costs her £80 per week. Her income from state and private pensions is £120 per week, which would entitle her to £21.33 per week from Pension Credit (made up of £4.05 from the Guarantee Credit and £17.28 from Savings Credit). If Susan had no additional savings she would be entitled to have her whole rent paid by Housing Benefit.

On the other hand, if Susan had savings of £14,000 she would no longer receive income from the Guarantee Credit but she would still receive Savings Credit of £14.93 per week.

Her deemed income in the calculation for her Housing Benefit entitlement could be £150.93 per week.

£150.93 = £14.93 (income from Savings Credit) + £120 (income from state and private pensions) + £16 (deemed income from savings)

*This is £7.13 above the personal allowance for Housing Benefit (£143.80 per week in 2008/9), which would reduce her income from Housing Benefit by £4.63 per week (£7.13 * £0.65). So Susan would receive Housing Benefit worth £75.37 per week towards the cost of her rent.*

If her savings were £18,000, Susan would not be eligible to receive any Housing Benefit (since her savings would be above the £16,000 limit).

Sources

Department for Work and Pensions (DWP) (2006) *A new deal for welfare: Empowering people to work*
www.dwp.gov.uk/welfarereform/docs/A_new_deal_for_welfare-Empowering_people_to_work-Full_Document.pdf

First Tier: Council Tax Benefit

Council Tax Benefit is a means-tested benefit that is designed to help individuals pay their council tax. Like Housing Benefit, it is paid to singles or couples based on their income. This includes some income from employment, state and private pensions, notional income from capital and Savings Credit.

The maximum amount of Council Tax Benefit is an amount equal to the person's (or couple's) liability to pay council tax, subject to certain restrictions. This amount is paid if the individual is eligible for Guarantee Credit.

Council Tax Benefit is reduced once income reaches a personal allowance of £143.80 per week in 2008/9⁴. If the claimant's income is above the personal allowance level, then the amount of Council Tax Benefit is reduced at the rate of 20p for every £1 of additional income. No benefit is payable if claimants have capital of more than £16,000, unless they are also eligible for Guarantee Credit. Higher personal allowances can apply for individuals who are eligible for premiums for Pension Credit.

There is a 'band E restriction' for Council Tax Benefit. The effect of this restriction is that claimants whose property falls into Bands F, G or H are awarded Council Tax Benefit as if their property was in Band E.

Second Adult Rebate (SAR) is a means-tested benefit but it is not assessed on the income and capital of the person liable to claim it. It aims to compensate people who pay council tax but who are not able to claim a single person discount because there is a second adult present in their household.

A single person discount can reduce a person's liability to council tax by 25%, if they are the only adult living in the property. If a second adult is present, SAR can rebate up to 25% of the council tax paid by the claimant. 25% is paid if the second adult is in receipt of Income Support or Jobseeker's Allowance (IB), and the amount is reduced if they have higher levels of income.

Whenever someone claims main Council Tax Benefit, SAR is also calculated. The claimant is then awarded whichever benefit (main CTB or SAR) is most advantageous to them. In practice, there are very few awards of SAR⁵.

⁴ £215.50 per week for couples

⁵ There were 5.0 million claimants of Council Tax Benefit at this date, compared to 35 thousand claimants of SAR.

Example

Tim and Kate are a married couple and they are both above state pension age. Their Council Tax liability is £12.25 per week. Their combined income from state pensions is £200 per week, which would entitle them to £21.87 per week from Pension Credit (made up entirely of Savings Credit).

Even if they had no additional savings Tim and Kate would still not be entitled to a Council Tax rebate of 100% of their liability because their deemed income of £221.87 per week (£200 + £21.87) is above the personal allowance for couples of £215.50 per week in 2008/9.

*Their deemed income is therefore £6.37 above the personal allowance, which would reduce their income from Council Tax Benefit by £1.27 per week (£6.37 * £0.20). So Tim and Kate would receive a Council Tax rebate worth £10.98 per week.*

If Tim and Kate did have savings but these were above the £16,000 limit, they would not be eligible to receive any Council Tax Benefit.

Source

Department for Work and Pensions (DWP) *Housing Benefit and Council Tax Benefit Quarterly Statistical Enquiry*, November 2006, Table HB 2.4.

First tier: Other first tier benefits

Individually Assessed Benefits

Disability-related benefits such as Attendance Allowance are payable if individuals satisfy the qualifying criteria – for instance:

- Attendance Allowance - lower rate of £44.85 per week (from April 2008) – payable if the individual needs personal care during either the day or the night. Attendance Allowance can only be claimed before age 65.
- Attendance Allowance - higher rate of £67.00 per week – payable if the individual needs personal care during both the day and the night.
- Disability Living Allowance – consists of two elements - a care component of between £17.75 and £67.00 per week for personal care, and a mobility component of between £17.75 and £46.75 per week. This can only be claimed before 65, although payment can continue after 65.
- Carer's Allowance – of £50.55 per week is payable to those spending at least 35 hours a week looking after someone receiving certain disability benefits including Attendance Allowance and Disability Living Allowance⁶.

Attendance Allowance and Disability Living Allowance are tax free, are not means-tested and do not count as income for the purposes of assessing eligibility for other benefits (such as Pension Credit, Housing Benefit and Council Tax Benefit).

Carer's Allowance is not payable to those who earn more than £95 per week and can be reduced if individuals receive other state benefits. It is taken into account as income for the purposes of assessing eligibility for means-tested benefits, although an individual in receipt of Carer's Allowance may qualify for a carer premium in Pension Credit.

Near Universal Benefits

Paid irrespective of income or assets, including:

- Christmas Bonus - £10 per recipient of BSP - paid annually during November and December⁷.
- Winter Fuel Payment - £200 per household where at least one person is age 60 or over, and £300 per household where at least one person is aged 80 or over - paid annually in December⁸.
- Free NHS prescriptions and eye tests for those over 60.
- Free TV Licences for those over 75.

⁶ Carer's Allowance is a maximum of £50.55 per week from April 2008, but is reduced by any other income the individual receives. Effectively this only benefits those carers with no retirement pension (mostly women) or a reduced rate of retirement pension.

⁷ As not everyone receives the BSP, this benefit is not universal

⁸ For 2008/9 the Government has promised that, alongside the WFP, an additional one-off payments of £100 will be made to households with someone aged over 80 and £50 to households with someone aged over 60

- Free central heating installed for people receiving Pensions Credit and a £300 discount for other pensioners.
- Free off-peak local area bus travel for those aged over 60, to be extended to off-peak nationwide bus travel from April 2008.

Tax Allowances

- The personal allowance (amount of income receivable before income tax becomes payable) is £9,030 for people aged between 65 and 74 and £9,180 for people age 75 and over. This compares to an allowance for the under 65s of £6,035 in 2008/9⁹.
- The married couple's allowance is £6,535 for people born before 6 April 1935 and under 75 years old, and £6,625 for those aged 75 and above. Tax relief of 10% is given on income in this band. Where income exceeds £21,800, any married couple's allowance is reduced at the rate of £1 for every £2 of 'excess' income, to a minimum of £2,540¹⁰. Personal allowances reduce at the same rate, to a minimum of £6,035.

⁹ Includes a one-off increase of £600 for 2008/9 announced in May 2008. The Government has not yet announced whether the increase will apply in future years.

¹⁰ This is the notional value of the married couple's allowance to those aged under 65, which was abolished with effect from the 2000/1 tax year

Second tier: Graduated Retirement Benefit (GRB)

The Graduated Retirement Benefit (GRB) was a compulsory scheme introduced in April 1961 through the National Insurance Act 1959. It was discontinued from April 1975.

As with all state schemes the pension is payable from SPA, although commencement can be delayed and increments earned, and is funded on a pay-as-you-go basis. Once in payment, the pension increases in line with prices¹¹.

Employees, who were not members of an occupational pension scheme, and whose weekly earnings exceeded the minimum threshold of £9.00 (in 1960's cash terms) paid graduated contributions in addition to their NI Class 1 contributions. These graduated contributions were converted into 'units' of graduated retirement pension. For men each £7.50 of graduated contributions purchased one unit of graduated retirement pension, whereas for women each £9.00 purchased one unit. From 2010 the terms of conversion will be equalised at £7.50 per unit purchased – this coincides with the commencement of the changes to the SPA for women.

The maximum number of units that could be purchased was 86 for a man and 72 for a woman – equivalent to total contributions of £645 and £648 respectively. A full-time manual male employee on average weekly earnings - £15.07 in 1961 rising to £55.70 in 1975 - would, by 1975, have paid approximately 83%¹² of the maximum.

Those who had paid sufficient contributions to secure the maximum pension ceased paying graduated contributions. This limited the tax raising capability of the scheme. By 1975 many people had reached – or were close to reaching – maximum benefits.

The pension is taxable as earned income and a 50% widow(er)'s pension is automatically provided. The maximum weekly benefit amount for the 2008/9 tax year, ignoring widows' pensions and increments, is £9.44 for men and £7.91 for women.

A man on average earnings¹³ and making graduated contributions between 1961 and 1975 would, if retired, receive a graduated retirement pension of approximately £7.25 per week. The equivalent figure for a woman, employed throughout the same period, and on average earnings for a full-time manual female employee is £1.69 per week. The actual

¹¹ Indexation was introduced in 1978

¹² PPI calculation

¹³ Average earnings for a full-time manual male employee between 1961 and 1975

average figures (2003/4)¹⁴, including any inherited spouse's benefits, are £3.55 per week and £1.29 per week for men and women respectively.

Sources

Department for Work and Pensions (DWP) (2005) *A Guide to State Pensions -NP46 Section – Increases payable with your state pension - Graduated Retirement Benefit*

www.thepensionservice.gov.uk/pdf/np46/np46apr05.pdf

Department for Work and Pensions (DWP) (2006) *Abstract of Statistics 2005 Section 5 - Rates of Benefit*

www.dwp.gov.uk/asd/asd1/abstract/Abstract2005.pdf

Department for Work and Pensions (DWP) (2007) *DWP Tabulation Tool*

www.dwp.gov.uk/asd/tabtool.asp

¹⁴ PPI calculation from DWP (2004) *State Pension Summary of Statistics* September 2004
www.dwp.gov.uk/asd/asd1/state_pension/RP_Sept04.xls

Second tier: State Earnings Related Pension Scheme (SERPS)

SERPS was introduced in 1978 as a replacement for the Graduated Retirement Benefit. It was established under the Social Security Pensions Act 1975 and was funded through National Insurance contributions on a pay-as-you-go basis. Subsequent changes have reduced the amount individuals can accrue through SERPS contributions, and from 2002/3 SERPS was replaced with State Second Pension (discussed in later sections).

SERPS was originally scheduled to provide a pension of 25% of band earnings – annual earnings up to a maximum of 53 times the weekly Upper Earnings Limit (UEL), and less a deduction of 52 times the weekly Lower Earnings Limit (LEL)¹⁵ – linking the pension payable to earnings while in employment. The pension would be higher for higher earners, but capped.

SERPS is payable from SPA and is taxable. Once in payment, it increases in line with prices.

All employees were members of SERPS, and have earned SERPS pension for any periods of employment, unless they:

- earned below the Lower Earnings Limit, or
- were aged over the SPA, or
- were a married woman or widow paying reduced rate NI contributions, or
- were a member of a contracted-out occupational pension scheme.

No SERPS pension was earned for periods of self-employment or unemployment.

The accrual rate was 1.25% of band earnings for each of the ‘best 20 years’ of membership. The best 20 years acted as protection for those with fluctuating earnings, with periods of self-employment or with periods outside the labour force. Those reaching SPA prior to 1998/9 would have less than 20 years of membership, and so accrued a smaller benefit.

¹⁵ Originally the LEL was not deducted until the year before reaching SPA. Subsequent calculation changes led to the LEL being deducted in the year of accrual. 53 times the weekly UEL is used where an individual has more than one job and is paid by more than one employer at the same time. For someone remaining in the same employment throughout the tax year, the maximum is 52 times the weekly UEL.

Table 8: Years in membership of SERPS for men and women reaching SPA between 1985 and 2027

Reaching SPA in:	Years of Membership of SERPS - Men	Years of Membership of SERPS - Women
1985/86	7	7
1990/91	12	12
1995/96	17	17
2000/01	22	22
2005/06	27	27
2017/18	39	39
2022/23	44	44
2027/28	49	45

In the Social Security Act of 1986 measures were introduced to reduce the value of future SERPS accruals:

- The best 20 years rule was removed and replaced by lifetime revalued band earnings. This disadvantaged most those with fluctuating earnings or with an incomplete employment record.
- The accrual rate was reduced for those reaching SPA after 1998/9 – the long-term target for accrual after 1987/8 was reduced from 25% to 20% of revalued band earnings.

From 1978, members could contract-out of SERPS and into an employer’s pension scheme. In addition from 1988 instead of accruing a SERPS pension members could contract-out and receive a rebate into a personal pension instead¹⁶.

The 1995 Pensions Act introduced a further change to the calculation method – the overall effect of which was to reduce entitlement further.

In 2002/3 SERPS was replaced with State Second Pension (S2P). There will be no impact on SERPS benefits already earned. The maximum combined benefit from SERPS and S2P that can be received by anyone at or above the UEL¹⁷ since 1978/9 and reaching SPA in 2008/9 is £151.10 per week¹⁸.

Sources

Department for Work and Pensions (DWP) (2005) *A Guide to State Pensions -NP46 Section – The State Earnings-Related Pension Scheme (SERPS)*
www.thepensionsservice.gov.uk/pdf/np46/np46apr05.pdf
 Reardon A. (2002) *Zurich Pensions Handbook*

¹⁶ See RN Second tier: Contracting-out

¹⁷ 53 times the weekly UEL per year

¹⁸ PPI calculation. This combines figures for SERPS plus S2P. If SERPS had continued this would not have been different since effectively S2P has no impact for those earning above the Upper Earnings Threshold of £31,100 (2008/9).

Second tier: Original SERPS calculation

Each tax year, an employee would accrue a SERPS pension unless they

- earned below the Lower Earnings Limit or
- were aged over the SPA or
- were a married woman or widow paying reduced rate NI contributions or
- were a member of a contracted-out occupational pension scheme.

The annual accrual was based upon band earnings, which are then revalued to SPA to reflect the increase in National Average Earnings (NAE) over that intervening period. On reaching SPA the pension would be calculated as 1.25% of revalued band earnings for each of the best 20 years.

Table 9: SERPS build up for individuals reaching SPA in 2008/9, earning NAE throughout, and if S2P had not replaced SERPS

Tax year	Earnings from employment ¹⁹	52 x weekly LEL	52 x weekly UEL	Earnings on which NIC payments based ²⁰	Revaluation factors ²¹	Revalued earnings ²²	LEL in tax year prior to reaching SPA	Revalued band earnings ²³
1978/79	£4,133	£910	£6,240	£4,133	623.8%	£29,771 ²⁴	£4,524	£25,247 ²⁵
1979/80	£4,659	£1,014	£7,020	£4,659	538.8%	£29,762	£4,524	£25,238
1980/81	£5,730	£1,196	£8,580	£5,730	433.7%	£30,579	£4,524	£26,055
2006/07	£27,815	£4,368	£33,540	£27,815	4.1%	£28,955	£4,524	£24,431
2007/08	£28,590	£4,524	£34,840	£28,590	0%	£28,590	£4,524	£24,066
Total								£739,745
Best 20 Years								£496,611

Total revalued earnings for the best 20 years are £496,611 giving an annual SERPS pension of £6,208 (1.25% *£496,611).

Sources

Department for Work and Pensions (DWP) (2005) *A Guide to State Pensions - NP46 Section - The State Earnings-Related Pension Scheme (SERPS)*

www.thepensionerservice.gov.uk/pdf/np46/np46apr05.pdf

Department for Work and Pensions (DWP) (2007) *Revaluation of Earnings Factors Orders* www.dwp.gov.uk/asd/reval.asp

¹⁹ Only earnings from employment secure SERPS benefits – earnings from self-employment are excluded

²⁰ No National Insurance Contributions (NICs) are payable – and no SERPS pension accrues – if earnings are below the LEL. If earnings exceed the LEL then NICs are payable – or treated as paid – and SERPS pension accrues up to the maximum of the UEL.

²¹ Revaluation factors are published each year by the DWP. No revaluation factor is applied to earnings in the tax year immediately prior to the individual reaching State Pension Age.

²² Restricted, where earnings exceed the Upper Earnings Limit, to 52* the weekly Upper Earnings Limit (assuming only one job during the year)

²³ Calculated as Revalued Earnings less the LEL in tax year prior to reaching state pension age

²⁴ Calculated as £4,133 + (£4,133 * 623.8%) = £29,771

²⁵ Calculated as £29,771 - £4,524 = £25,247

Second tier: Impact of changes to SERPS in the 1986 Social Security Act

The Social Security Act of 1986 introduced various new changes for accruals from 1988/9.

The 'best 20 years' rule was removed, so the SERPS pension would be based on band earnings throughout an individual's working life. To reduce the benefit further, the future SERPS accrual rate was reduced for those reaching state pension age after 1999/2000.

- For those scheduled to reach SPA in or after 2009/10 the overall target was reduced from 25% to 20% of band earnings
- For those reaching SPA between 2000/1 to 2008/9 the change will be smoothed in - for instance the post 1987/8 accrual rate for someone reaching SPA in 2000/1 is 24.5%, in 2001/2 is 24% and in 2002/3 is 23.5% reducing to 20.5% in 2008/9
- The accrual rate for membership of SERPS prior to 1988/9 was not reduced - so the overall benefit reduction is gradual - for instance if a man reaches SPA in 2018/9 the benefit will be calculated as 10 years at 25% and 30 at 20% giving an average of 21.25%. The overall accrual rate does not reduce to 20% until 2037/8 by which time all those who were members in 1987/8 would have reached SPA.

The overall effect was to reduce the SERPS pension for those reaching SPA in or after 1998/9. The impact was greatest for those with an incomplete earnings record or with fluctuating earnings.

David has earned average earnings since 1978/9 and reaches SPA in 2008/9. His total revalued band earnings are £739,745 and revalued band earnings for the best 20 years are £496,611. This gives him a pension under the original basis of £6,208 per year²⁶. Total revalued band earnings for 1978/9 to 1987/8 was £247,646 and for 1988/9 to 2007/8 was £492,099.

Given David is reaching SPA in 2008/9 the accrual rate for 1988/9 and thereafter is 20.5% under the revised basis, and the maximum period of membership is 30 years. His SERPS pension is therefore calculated as:

$$(25\% * £247,646 + 20.5\% * £492,099) / 30 = £5,426 \text{ per year.}$$

The effect of the 1986 changes is to reduce David's SERPS pension from £6,208 to £5,426 per year - a reduction of 13%.

Sources

Department for Work and Pensions (DWP) (2005) *A Guide to State Pensions -NP46* www.thepensionerservice.gov.uk/pdf/np46/np46apr05.pdf

Department for Work and Pensions (DWP) (2007) *Revaluation of Earnings Factors Orders* www.dwp.gov.uk/asd/reval.asp

²⁶ See RN Second tier: Original SERPS calculation

Second tier: Impact to changes to SERPS in the 1995 Pensions Act

The 1995 Pensions Act introduced another change to the calculation method for people reaching state pension age on or after 6 April 2000. The overall effect was to reduce further SERPS entitlement.

Prior to 6 April 1999 annual earnings up to a maximum of 53²⁷ times the weekly Upper Earnings Limit (UEL) were revalued in line with revaluation orders. Then the Lower Earnings Limit (LEL) applicable in the tax year prior to reaching SPA was deducted to give revalued band earnings.

Post 6 April 1999 each tax year band earnings will be calculated as annual earnings between a maximum of 53²⁸ times the weekly UEL and 52 times the weekly LEL. Band earnings would then be revalued in line with revaluation orders.

Historically the LEL has increased at a slower rate than National Average Earnings (NAE) on which the revaluation orders are based. The overall effect is therefore to reduce the revalued band earnings, and so reduce the SERPS entitlement.

For David, with a complete earnings record, post Social Security Act 1986 his SERPS entitlement was calculated as²⁹:

*$(25\% * £247,646 + 20.5\% * £492,099) / 30 = £5,426$ per year.*

The impact of the 1995 Pensions Act was to reduce David's total revalued band earnings in the first period to £230,732 and to £484,697 for the second period giving a SERPS pension of:

*$(25\% * £230,732 + 20.5\% * £484,697) / 30 = £5,235$ per year.*

This is equivalent to a further reduction of £191 per year - a 4% reduction.

Sources

Department for Work and Pensions (DWP) (2005) *A Guide to State Pensions -NP46* www.thepensionerservice.gov.uk/pdf/np46/np46apr05.pdf

Department for Work and Pensions (DWP) (2007) *Revaluation of Earnings Factors Orders* www.dwp.gov.uk/asd/eval.asp

²⁷ For someone remaining in the same employment throughout the tax year, the maximum is 52 times the weekly UEL

²⁸ For someone remaining in the same employment throughout the tax year, the maximum is 52 times the weekly UEL

²⁹ See RN Second tier: Impact of changes to SERPS in the 1986 Social Security Act

Second tier: Overall reductions in SERPS

The table below summarises the impact of the 1986 Social Security Act and 1995 Pensions Act legislative changes on SERPS provision for an individual reaching SPA in 2008/9.

David had a full employment record and average earnings. Frank had only 20 years of membership coinciding with David's 'best 20 years' of revalued earnings. Roy had a full employment record earning in excess of the UEL throughout.

Under the 1986 changes employees with a similar membership record, reaching SPA in a specific year would see a similar proportionate reduction in benefits. Those with an incomplete record would proportionately see a greater reduction in benefits.

The impact of the 1995 Pension Act changes is that all employees with SPA in a specific year would see the same flat-rate reduction in benefits in each year of SERPS accrual, irrespective of the level of their revalued earnings.

Table 10: Impacts of 1986 and 1995 reforms on annual SERPS pension

Individual reaching SPA in 2008/9			
	David - complete SERPS membership record earning NAE ³⁰	Frank - incomplete SERPS membership record	Roy - complete SERPS membership record earning in excess of UEL
Annual SERPS Pension			
Original Basis	£6,208 [20.8% of NAE]	£6,208 [20.8%]	£9,575 [32.0%]
After 1986 Social Security Act changes	£5,426 [18.2%]	£3,655 [12.2%]	£8,049 [26.9%]
After 1995 Pensions Act changes	£5,235 [17.5%]	£3,513 [11.8%]	£7,857 [26.3%]

The overall impact of all these changes for someone with average earnings reaching SPA in 2008/9 is a 16% reduction for David (an individual with a full employment record) and a 43% reduction for Frank (someone with an incomplete record). For those reaching SPA in subsequent years, these reductions will be greater.

³⁰ Uses projected NAE for 2008/9 of £29,890

Second tier: State Second Pension (S2P)

State Second Pension (S2P) is a compulsory scheme introduced in 2002 as a replacement for SERPS under the Child Support, Pensions and Social Security Act 2000. The aim of S2P is to target greater resources at the lower-paid than SERPS did, and to provide pension benefits for some carers and individuals with a long-term disability.

S2P operates in a similar way to SERPS. It is funded through National Insurance contributions on a pay-as-you-go basis. The pension is payable from SPA and is taxable. All employees are members of S2P, and earn S2P pension for any periods of employment, unless they:

- earn below the Lower Earnings Limit or
- are aged over SPA or
- are a married woman or widow paying reduced rate NI contributions.

The introduction of S2P created some additional complexities surrounding contracting out³¹.

No S2P is earned for periods of self-employment or unemployment.

S2P pension at SPA will be based on revalued band earnings³². However the accrual of benefit is more complicated:

- Those earning below the Lower Earnings Threshold of £13,500 per year (2008/9) will be much better off – they will be treated as if they earn £13,500 and in addition the accrual rate will be twice the rate under SERPS
- Those earning between £13,500 per year and £31,100 per year will also be better-off – they will accrue benefit at a faster rate than under SERPS, with the additional benefit reducing as earnings increase
- Those earning above the Upper Earnings Threshold of £31,100 per year (2008/9) are no worse off – they will accrue benefits at the same rate as under SERPS
- Some carers³³ (caring for children under 6-years old or disabled relatives) and people with a long-term illness or disability will be treated as if they are employees earning at the LET.

³¹ See RN Second tier: Contracting-out of S2P

³² See RN: Impact of changes to SERPS in the 1995 Pensions Act

³³ Not all carers will accrue benefits, as they must care for the entire financial year. Shorter spells of caring or those that straddle two financial years will not qualify.

Changes in the Pensions Act 2007

The changes in the Act will increase the number of people accruing State Second Pension. Starting from April 2010, the changes will allow people to be deemed to be earning at the LET by combining earnings below the LET with a more generous system of weekly credits.

The new earnings credits, of 1/52 of the qualifying earnings factor for the year, are available in respect of each week in which the person was:

- awarded child benefit for a child under 12 or
- a foster parent or
- caring for someone with a qualifying disability benefit for at least 20 hours a week or
- entitled to Carer's Allowance or
- entitled to Severe Disablement Allowance or long-term Incapacity Benefit. The labour market attachment test would no longer apply to disabled people from April 2010.

People earning at or above the LET will continue to accrue State Second Pension according to the band of earnings they are in until the new simplified State Second Pension is introduced³⁴.

³⁴ See RN: Second tier: S2P accrual

Second tier: S2P accrual

After the 1986 and 1995 reforms an employee with a full work record reaching SPA after 2008/9 could expect a SERPS pension of approximately 20% of their band earnings. S2P is designed to give lower earners a higher benefit than this.

Under SERPS the benefit accrual was based on all earnings between the Lower Earnings Limit (LEL) and the Upper Earnings Limit (UEL) whereas with S2P band-earnings are divided into 3 separate bands:

- The first band is between the LEL and the Lower Earnings Threshold (LET) (£4,680 and £13,500 from April 2008).
- The second band is between the LET and the Upper Earnings Threshold (UET) (£13,500 and £31,100).
- The third band is between the UET and the UEL (£31,100 and £40,040).

Under SERPS an individual with potentially 49 years of membership would each year accrue a pension of 20%/49 of band-earnings³⁵. In comparison under S2P the accrual rate varies with the bands. So for an individual with a potential total membership of SERPS and S2P of 49 years the accrual rates for S2P are:

- 40%/49 - for earnings in the first band
- 10%/49 - for earnings in the second band
- 20%/49 - for earnings in the third band

In addition where earnings are below the LET then under S2P the individual is treated as if they earned at that threshold. Qualifying carers or disabled people are also treated as if they earned at that threshold.

The UET is deliberately set such that at this point the total benefit accrual is equivalent for both SERPS and S2P i.e. $20\% * (£31,100 - £4,680) \approx 40\% * (£13,500 - £4,680) + 10\% * (£31,100 - £13,500)$ ³⁶. For this to occur the second band is roughly twice as wide as the first band - the difference between £31,100 and £13,500 is £17,600 whereas the difference between £13,500 and £4,680 is £8,820.

³⁵ If they spent their entire working life under the post 1986 system

³⁶ Exact equality does not hold due to rounding

The table below compares the accrual under SERPS with the accrual under S2P for 2008/9.

Table 11: Comparison of SERPS and S2P accrual - 2008/9³⁷

Earnings from employment	Band earnings	SERPS accrual ³⁸ (p.a.)	S2P accrual (p.a.)	Gain from S2P
Carer - £0	-	-	£72	£72
£3,000	-	-	-	-
At LEL - £4,680	-	-	£72	£72
£4,880	£200	£1	£72	£71
£10,000	£5,320	£22	£72	£50
At LET - £13,500	£8,820	£36	£72	£36
£19,000	£14,320	£58	£83	£25
£25,000	£20,320	£83	£95	£13
At UET - £31,100	£26,420	£108	£108	-
£35,000	£30,320	£124	£124	-
At UEL - £40,040	£35,360	£144	£144	-
£50,000	£35,360	£144	£144	-

Changes in the Pensions Act 2007

The Act makes provisions for the Government's intention to introduce a much simpler flat-rate State Second Pension (S2P) in future. The earnings related component of S2P will become smaller over time, and eventually disappear by around 2030 while from 2012, the value of the flat-rate component would be the same in every year³⁹.

The first step will be to merge the second and third earnings bands, so that all earnings exceeding the LET (but not exceeding the UEL) will fall into the second band and accrue S2P at a rate of 10%. This change will take effect from April 2010. This was due to happen over time until the Act brought the indexation of the thresholds forward.

In addition, from a date yet to be determined, the current 40% accrual band (the first band) for earnings between the LEL and the LET will be replaced with a weekly flat rate accrual amount of £1.50, which gives an equivalent annual amount of £78.00. This will be accrued by all contributors and people credited into S2P in respect of each year of contribution.

For a time, the additional earnings-related component of S2P, accruing at 10%, will remain in place. This component will ultimately be withdrawn by around 2030, leaving a flat-rate benefit.

³⁷ Assumes potentially 49 years of service

³⁸ Annual amount

³⁹ See PPI BN 35 - *State pension simplification?*

www.pensionspolicyinstitute.org.uk/uploadeddocuments/Briefing%20Notes/PPI_Briefing_Note_35.pdf

Second tier: Contracting-out

Since the introduction of SERPS in 1978 it has been possible for employers to set-up an occupational pension scheme that is contracted-out of SERPS. All employees who were members of the scheme would automatically be contracted-out. Both the employer and employee would pay lower National Insurance contributions. Each year instead of accruing a pension within SERPS the individual would earn benefit within the scheme.

Until 1996 a key requirement was that the pension provided by a defined benefit scheme could never have been worse than the pension SERPS would have provided. Since 1997 the rules require that an actuary has estimated that at least 90% of the scheme membership will be better off than had they remained in SERPS/S2P.

Since 1988 individuals who were not members of a contracted-out occupational scheme have been able to contract-out of SERPS and, each tax year, instead of accruing a pension within SERPS, receive a rebate into a personal pension (or stakeholder pension). The decision is not irrevocable – they can contract-in and out as many times as they wish, for complete tax years. The accumulated fund arising from such rebates must be used to provide pension benefits. From April 2006, it is possible to take some of this fund as a tax-free lump-sum⁴⁰.

The Pensions Act 2004 removed the minimum age (60) from which benefits can be paid, enabling them to be paid at the same age as all other rights (50 increasing to 55 in 2010). Legislation also removed the requirement that the pension bought must include indexation. Members will still be able to opt for an index-linked pension if they wish. However, pensions that are in payment before the changes came into force in April 2005 will not be affected.

If the individual is married, benefits must now also provide a 50% widow(er)'s pension. The overall aim is for the pension arising from contracting-out to be greater than the SERPS pension given up.

When contracting-out into personal pensions was first introduced in 1988 the decision whether to contract-out or remain in SERPS was influenced by age. The flat-rate rebates were particularly generous at young ages, but were seen as insufficient at older ages⁴¹.

⁴⁰ See RN Third Tier: Options for pension withdrawal

⁴¹ A flat-rate rebate was declared for each tax year for 1987/8 to 1992/3. A 2% incentive was also payable unless the individual had been a member of their occupational scheme for at least 2 years and had voluntarily left the scheme after 5 April 1988 whilst continuing to work for that employer. From 1993/4 the 2% bonus ceased and a 1% age addition was payable in those tax years where the individual was either already aged 30 at the start of the relevant tax years or would reach their 30th birthday within that tax year.

From 1997/8 the basis for calculating the rebates changed, and age-related rebates were introduced for people contracting-out into Defined Contribution occupational pensions and personal pensions⁴². The key points about age-related rebates are:

- The rebates are estimated to be the actuarial equivalent of the SERPS benefits given up.
- They include a margin to cover the expenses that would be levied by a 'lower-cost' pension provider.
- On an actuarially equivalent basis the rebates for women born prior to 6 April 1955 should be higher than for men of the equivalent age⁴³. In order to satisfy equal-treatment requirements, where the actuarially equivalent rebate rate for men was lower than the rate for women, rebates for men were increased to the higher rate for women.
- Rebates were capped for 1997-2002 to a maximum of 9% of band earnings and for 2002-2007 to a maximum of 10.5% of band earnings. From April 2007, the rebate cap will be set at 7.4%⁴⁴.

The imposition of a cap means that at older ages the actual rebate is less than the actuarial equivalent of the SERPS/S2P benefits given up. The age at which this first occurs – often called the pivotal age – varies for men and women and is different in different years.

Reports by the Government Actuary include tables of theoretical rebates for women prior to the imposition of the caps up to the age of 58 as at the start of the relevant tax year. The theoretical rebates published for ages 59 to 63 were based on accrual rates for men⁴⁵. The estimates can then be used to determine theoretical pivotal ages.

⁴² It is a statutory requirement that rebate rates be reviewed every 5 years. In March 2006 the Government set out the rebate rates that will apply from 2007. Statutory Instrument 2006 No. 1009, The Social Security (Reduced Rates of Class 1 Contributions, Rebates and Minimum Contributions) Order 2006 www.opsi.gov.uk/si/si2006/20061009.htm

⁴³ This is because such women, with a lower SPA, have a higher accrual rate and a pension which should on average be payable for longer and so the value of SERPS benefits given up is higher

⁴⁴ www.dwp.gov.uk/mediacentre/pressreleases/2006/mar/pens-049-020306.asp

⁴⁵ Note the maximum age of 59 for women and 63 for men since there is no accrual in the tax year in which an individual receives SPA

Table 12: Pivotal ages for contracting out of S2P

Pivotal ages ⁴⁶ - 1997/8 to 2006/7										
Tax year	97/8	98/9	99/00	00/1	01/2	02/3	03/4	04/5	05/6	06/7
Women	46	47	48	49	50	51	52	53	54	55
Men	54	54	55	56	56	58	58	59	60	61
Note: Age quoted is age as at 5 th April prior to start of relevant tax year										

Changes in the Pensions Act 2007

The Pensions Act 2007 provides for the abolition of contracting-out from Defined Contribution occupational schemes and personal pensions. The aim is to introduce this change in April 2012 or by the end of the next Parliament at the latest to coincide with the re-linking of the BSP with earnings growth. Once this takes effect, people will no longer be able to contract out of the State Second Pension through a Defined Contribution occupational and personal pension scheme. Only members of Defined Benefit pension schemes will have the option to contract-out.

Sources

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www.official-documents.gov.uk/document/cm67/6758/6758.pdf

⁴⁶ Pivotal ages for women are taken directly from the Government Actuary's Department (GAD) reports. Historical pivotal ages for men for 1997/8 to 2001/2 are approximate and estimated from the rebate rates for men 59 to 63. For 2002/3 and 2003/4 they are directly derived from the rates for men aged 59 using GAD assumptions and FSA methodology. From 2004/5 onwards taken directly from the GAD reports. The figures from 2007 onwards are not available from GAD reports.

Second tier: Contracting-out deduction and residual SERPS for accruals before 1997/8

Even when an individual has been contracted-out for tax years prior to 1997/8 in retirement they might still receive a pension from SERPS in relation to those years. This is because the SERPS replacement – either an occupational pension scheme or personal pension – only provides inflation-proofing up to 3% per year. If inflation is higher than this, the extra increase above 3% is paid through SERPS. From 1997/8 the SERPS replacements provide indexation up to 5% and no SERPS benefit is payable if inflation is higher.

In order to pay the appropriate amounts the Department for Work and Pensions calculate a gross SERPS entitlement – effectively the benefit the individual would receive had they not been contracted-out – and a separate Contracted-Out Deduction (COD) – the SERPS benefit they would have received had they been members of SERPS only for the years they were contracted-out. The net payment from SERPS will be the gross SERPS entitlement less the COD.

Alf reaches SPA, after working for an employer with a contracted-out pension scheme of which he was a member. Since 1978/9 he accrued a SERPS pension of £1,000 per year. Because he was always contracted-out this was matched by a COD of £1,000 per year. At SPA no SERPS is payable.

If inflation were 3% for each of the first 5 years and 4% thereafter then Alf would receive the following residual SERPS:

Table 13: Example - Residual SERPS received by Alf, if inflation were 3% for each of the first five years and 4% thereafter

Age	RPI at year end	SERPS accrual ⁴⁷ - start of year	COD ⁴⁸ - start of year	Residual annual SERPS payment
65	3%	£1,000.00	£1,000.00	£0.00
66	3%	£1,030.00	£1,030.00	£0.00
67	3%	£1,060.90	£1,060.90	£0.00
68	3%	£1,092.73	£1,092.73	£0.00
69	3%	£1,125.51	£1,125.51	£0.00
70	4%	£1,159.27	£1,159.27	£0.00
71	4%	£1,205.65	£1,194.05	£11.59
72	4%	£1,253.87	£1,229.87	£24.00
73	4%	£1,304.03	£1,266.77	£37.26
74	4%	£1,356.19	£1,304.77	£51.41

⁴⁷ SERPS accrual increases with RPI

⁴⁸ COD increases with lower of RPI and 3%

Second tier: Contracting-out of S2P

The replacement of SERPS with the more generous S2P has created some additional complications for contracting-out.

Contracting-out into an occupational pension scheme

If a defined benefit occupational pension scheme is contracted-out then the benefits it provides must meet or exceed a minimum standard. For instance benefits should be structured in such a way that at least 90% of the membership is better off compared to remaining in SERPS/S2P. The enhancements to S2P would have forced schemes to revise their benefit structures.

For relative simplicity for the schemes it was decided that contracting-out would continue for both Defined Benefit and Defined Contribution occupational pension schemes on terms similar to when SERPS was in operation:

- The rebates received by the scheme would be based on the accrual rate under SERPS
- The individual would also accrue a residual S2P benefit which is calculated as the difference between the S2P accrual and the SERPS accrual
- So anyone earning below the Upper Earnings Threshold £31,100 (2008/9) would accrue benefits in both their occupational scheme and in S2P

Contracting-out into a personal pension

If an individual is contracted-out into a personal pension then the rebate is based on the individual's actual earnings from employment and the actual S2P accrual rates for the different bands of earnings.

Those earning below £13,500 will in addition accrue S2P benefits within S2P, as the flat-rate part of S2P assumes earnings of £13,500. The S2P benefit will be based on the difference between their actual earnings and £13,500.

Table 14: Residual pension accrued in S2P if contracted-out 2008/9

Earnings from employment	S2P accrual (p.a.)	Residual benefit accrued in S2P if contracted-out into:	
		Occupational pension scheme	Personal pension
£3,000	-	-	-
At LEL - £4,680	£72	£72	£72
£4,880	£72	£71	£70
£10,000	£72	£50	£29
At LET - £13,500	£72	£36	-
£19,000	£83	£25	-
£25,000	£95	£13	-
At UET - £31,100	£108	-	-
£35,000	£124	-	-
At UEL - £40,040	£144	-	-
£50,000	£144	-	-

Second tier: Outcomes from contracting-out

There are a number of factors that could influence the outcomes when an individual contracts-out of the second tier. Some of them are listed here, in order to illustrate the complexity of the decision.

Clearly if an individual is at an age where the cap applies, the rebate is not fair value - it is worth less than the benefits given up and in such circumstances individuals may get better value by not contracting-out.

At younger ages the outcomes are influenced by a range of factors.

In calculating the rebates the Government Actuary makes assumptions about investment returns, increases in National Average Earnings, long-term interest rates available in the financial market and mortality improvements⁴⁹.

If actual experience is worse than expected then the individual will have lost out by contracting-out. The pension from contracting-out will be lower than the SERPS/S2P pension given up whereas if actual experience is better the individual will gain - the pension from contracting-out will be more than the SERPS/S2P pension given up.

Rebates are calculated on the assumption that the individual will be married at retirement and so will be required by legislation to purchase a 50% spouse's pension. However if at retirement they are single then they can use all the proceeds to purchase a single life annuity - the overall impact is that the pension could be around 10% higher than if a joint life pension had been purchased⁵⁰, although a spouse's pension would not be payable.

Rebates assume certain policy charges. If the actual charges are lower then the resultant fund will be higher. The reverse is also true.

SERPS/S2P pensions are only payable from SPA whereas the pension arising from contracting-out can be taken from age 60. Although the overall actuarial value is the same, the timing of payments might be more beneficial.

The contracting-out rebate is based on current legislation. The government could change accrued SERPS/S2P benefit by, for instance,

⁴⁹ Note, however, that the Government does not always implement the results from the Government Actuary's calculations

⁵⁰ Based on a range of market rates, assuming a non-smoking man buys a lifetime level annuity at age 65 with no guarantee. Under a joint life annuity, the spouse (of the same age) would receive an income worth 50% of the husband in the event of his death. Annuity rate information is taken from the FSA's Comparative Tables (www.fsa.gov.uk/tables) as at 30 May 2008. © The Financial Services Authority.

increasing SPA⁵¹. Individuals who had contracted-out would have gained by already receiving a rebate based on the existing legislation.

It is difficult and risky to predict the final pension from the accumulated fund of contracted-out rebates, as the value will depend on future investment returns and annuity rates⁵².

⁵¹ Which it plans to do from 2024 for both men and women

⁵² See RN Third tier: Options for pension withdrawal

Third tier: Overview of private pension provision

As with state provision, private provision is complicated. The legislative framework has altered over time, adding layers of new arrangements to those already available. In addition, individuals have varied employment histories. Many will retire with a number of pensions arising from both employer-sponsored schemes and individual arrangements.

The third tier section of *The Pensions Primer* is an overview of private pension provision as of 6 April 2008. Using a box format, it notes changes implemented as a result of the Pensions Act 2007 and that will come into place if the Pensions Bill 2007/8 is enacted later this year.

The Finance Act 2004, which took effect from 6 April 2006, includes a number of amendments designed to simplify the taxation of the UK private pension regime, effectively capturing all pensions under a single set of rules¹. Compared to the pre-April 2006 system, there is no limit on the amount of pension saving an individual can build up in a registered pension scheme². Instead, the amount by which an individual can benefit from tax advantages is controlled by two 'allowances': annual and lifetime. These allowances apply to each individual, and across all registered pension schemes that the individual uses for providing benefits, regardless of the time of joining³.

An individual can make contributions to any number of private pension schemes and receive tax relief on the amount saved in that year up to the greater of £3,600 and 100% of annual UK taxable earnings. If in any year the contributions paid by and for the member to money purchase type arrangements, plus the increase in value of benefits under defined benefit type arrangements, are more than the annual allowance (AA) (for the tax year 2008/9 this is £235,000), the excess will be taxed at the rate of 40%. The tax charge is payable by the individual.

Individuals who do not pay tax receive tax relief at the basic rate (20%) on all contributions to a private pension in one year up to a limit of £3,600.

The lifetime allowance (LTA) will test an individual's pension savings when they come to take their benefits, and so regulates the amount of tax relief an individual is entitled to on their pension savings over a lifetime. Any pension savings in excess of the LTA, set at £1.65 million in 2008/9⁴,

¹ See Inland Revenue (IR) (2003) *Simplifying the taxation of pension: the Government's Proposals* and Her Majesty's Treasury (HMT) (2004) *Prudence for a purpose: A Britain of stability and strength*, Budget report www.hm-treasury.gov.uk/budget/budget_04/budget_report/bud_bud04_repindex.cfm

² All pension schemes must be registered with the HM Revenue and Customs in order to qualify for tax relief and exemption from various taxes

³ Although exemptions to the lifetime allowance are available to protect existing rights

⁴ This is set to rise in stages to £1.8 million by 2010/11

will be taxed at the LTA charge of 25% if the benefits are taken as a pension, or 55% if taken as a lump sum.

Private pension provision can be made through:

- Employer-sponsored pension schemes (including occupational pension schemes)
- Individual arrangements, such as retirement annuities and personal pensions (including stakeholder pensions)

Employer sponsored provision

Some employers run *occupational pension schemes*. Such schemes are arranged under their own trust deeds and rules. The employer usually contributes to these schemes, and more often than not an employee contribution is required. Most schemes are arranged through a single employer, although there are a few industry-wide arrangements.

Such schemes can either be *Defined Benefit (DB)* – where the final pension is based on earnings and length of service - or can be *Defined Contribution (DC)* – where the employer contributes a specified amount, usually expressed as a percentage of salary. The actual level of pension from a DC scheme depends on the accumulated fund and the annuity rates applicable at retirement.

Hybrid pension schemes are a relatively recent development. These combine DC and DB features within the same pension. For example, a ‘nursery scheme’ works like a DC for younger staff, but becomes related to final salary as the member gets older.

The Pensions Act 2004 established the Pension Protection Fund to provide some guarantee of benefits to members of under-funded DB schemes when the sponsoring employer has become insolvent⁵. The Act also introduced a number of changes to the regulatory framework governing occupational pensions, including the replacement of the Occupational Pensions Regulatory Authority with a new body, the Pensions Regulator.

In some cases occupational schemes will be contracted-out, which means the scheme is providing benefits in place of the State Second Pension (S2P)⁶. In this case, the employer and employee’s National Insurance contributions are reduced or ‘rebated’ by the Government, and this amount is known as the contracted-out rebate. In DB schemes the rebate will help fund the benefits, whereas in DC schemes the rebate will usually be in addition to the employee and employer contributions. Where the scheme is not contracted-out, the individual has the option of contracting-out on an individual basis.

⁵ The PPF does not provide support to schemes that belong to employers who became insolvent prior to the establishment of the PPF. To help groups close to retirement who do not fall under the support of the PPF, the Government established the Financial Assistance Scheme (FAS).

⁶ See RN Second tier: Contracting-out

Changes in the Pensions Act 2007

The Act provides for the abolition of contracting-out of the State Second Pension for Defined Contribution occupational schemes and personal pensions. The aim is to introduce this change in April 2012 or by the end of the next Parliament at the latest to coincide with the re-linking of the BSP with earnings growth. It should be noted that although the majority of active members in Defined Benefit schemes are in a scheme that is contracted-out of the State Second Pension, only a small proportion of members in DC schemes are currently contracted-out of S2P.

A further option, available since 1988, has been for the employer to make contributions to an employee's *personal pension*. Contributions could be solely from the employer or from both the employee and the employer. The employer can also arrange a *group personal pension*. Each individual member will have their own plan but charges will typically be lower, at least while the member remains in that employment, reflecting the group nature of the contract. In addition the sponsoring employer will usually make some contribution.

Since 2001 there has been the option of employee and employer contributions into a *stakeholder pension*, or a *group stakeholder pension*. Stakeholder pensions are a type of low-cost personal pension with limits on the charges that providers can impose. All employers with 5 or more employees, who do not already have comprehensive pension provision⁷, have been required to designate a stakeholder provider but they are not required to make any contribution.

Employees can contract-out of S2P and receive rebates either into their group pension or into a standalone arrangement.⁸

If an individual in an occupational scheme wishes to increase their pension provision further then they have the option of paying *additional voluntary contributions* (AVCs). These AVCs could either be used to purchase extra years of service – at retirement the total pension will be based on earnings and actual service plus any added years purchased – or could be invested and the resultant pension would depend on the accumulated fund and annuity rates applicable at retirement. Since 1987 there has also been the option of a *free-standing AVC* (FSAVC) – this is similar to an AVC except it is a standalone arrangement usually provided by a life assurance company. A FSAVC will only offer money-purchase benefits – it cannot offer added-years. The charges on an AVC are often lower than in other individual arrangements and in some cases the employer will match an AVC contribution.

⁷ An occupational pension scheme or a GPP with a minimum 3% contribution, or some combination, open to all employees

⁸ Employees could contract out of SERPS before it was replaced with S2P in 2002

Changes proposed in the Pensions Bill 2007/8

The Pensions Bill 2007/8 proposes to dramatically reform private pension provision in the UK. By introducing a new, low cost national pension scheme called personal accounts, the Government aims to address the problem of undersaving for retirement identified by the Pensions Commission. Auto-enrolment into the new scheme could for the first time give many people access to a low cost pension with an employer contribution.

Although many details are yet to be finalised, the basic framework for personal accounts would be:

- Auto-enrolment for all employees aged over 22 and below state pension age, and earning more than £5,035 (in 2006 earnings) a year into a personal account (or an equivalent employer-based pension scheme), with the opportunity to opt out.
- A minimum contribution of 4% from the employee on band earnings between £5,035 and £33,540 (in 2006 earnings) a year. This would be matched by a minimum 1% contribution of band earnings from the Government and a compulsory 3% contribution of band earnings from the individual's employer.
- Low charges, possibly as low as 0.5% of assets under management in the short term and below 0.3% in the long term.

The Government would provide support for all employers during the introduction of the compulsory employer contributions by allowing a phase in period of three years. Furthermore, people under age 22 and over state pension age, non-employees, such as the self-employed and non-workers will be able to opt-into the scheme but will not benefit from the compulsory employer contribution.

Individual pension arrangements

Between 1971 and 1988 employees with no employer provision and the self-employed could contribute to a retirement annuity. New retirement annuity policies were no longer available from 1988, although contributions can still continue to be paid. From 1988 they could use a personal pension and from 2001 they also had the option of a stakeholder pension. There are no restrictions on the number of policies an individual can hold and in any tax year an individual can make contributions to any combination of the three types of plan. From 1988 employees could elect to contract-out of SERPS and instead receive a rebate into a personal pension, called an appropriate personal pension. From 2001 such rebates could alternatively be directed into their stakeholder pension.

Options for pension withdrawal

On 6 April 2010 the minimum age at which private pensions can be taken will increase from 50 to 55. The Finance Act 2004 introduced legislation

to allow more flexible retirement. It is possible to begin withdrawing a pension, once over the minimum retirement age, whilst still working.

When individuals opt to withdraw some of their pension saving, they can choose one or a combination of three options:

- Cash lump sum. 25% of a pension fund can be taken as one-off a tax-free lump sum, depending on occupational scheme rules. If an individual's entire pensions savings (including the value of pensions already in payment) are less than 1% of the LTA, it may be possible to 'trivially commute' and take the whole fund as a lump sum, with up to 25% being tax-free and the remainder being taxed as income under PAYE.
- Income withdrawal or 'drawdown'.
- Annuity. An insurance product that pays an income from the date of purchase until the date of death.⁹ Annuity payments are usually taxed as income.

Prior to April 2006, an individual when reaching age 75 had no option but to purchase an annuity. Now, if a person has not opted for an annuity by the time they reach age 75, unless they are in a Defined Benefit scheme, they must begin withdrawing their pension benefits, either by purchasing an annuity or by the additional option of an alternatively secured pension (ASP).

An ASP allows some of the pension fund to be withdrawn as an income, whilst the remaining sum continues to be invested for future income. When ASPs were first introduced in April 2006, there was no minimum income withdrawal requirement. This meant that individuals could leave their pension invested indefinitely and transfer its value to a dependant or other scheme member on their death. However, the Government has indicated that ASPs are only intended for a small group of people who have a principled religious objection to buying an annuity¹⁰.

Changes introduced in the Finance Act 2006 and the Finance Bill 2007 aim to tighten up the rules around ASPs, to prevent the passing of tax-favoured funds to other members on or before death. The changes mean that from April 2007, the minimum income that an individual must withdraw from an ASP is 55% of the annual amount of a comparable annuity for a 75 year old that could be purchased with the assets of the ASP fund¹¹. The maximum income is 90% of the relevant annuity. Any lump sum death benefits passed to other scheme members will be taxed at up to 70% and could also be subject to inheritance tax.

⁹ An annuity insures against an individual's money running out because he or she lives longer than expected

¹⁰ FSA Fact-sheet

www.moneymadeclear.fsa.gov.uk/pdfs/income_withdrawal.pdf

¹¹ Budget 2007 BN19 21 March 2007

Third tier: Employer-sponsored pension provision

There are a number of different options available to employers who wish to provide pension arrangements for their employees.

Defined Benefit (DB) occupational pension schemes

There are two main types of DB schemes: 'final salary' and career average.

The benefit arising from a final salary scheme is based on an individual's earnings at, or close to, leaving the scheme and their length of service.

Less common are career average schemes which offer a benefit based on average salary over the course of scheme membership, revalued to take account of inflation throughout the individual's time within the scheme.

Benefits are usually expressed in terms of pension – but the individual has the option of taking a reduced pension and receiving a tax-free lump sum instead. A scheme might typically promise a pension of 1/60th or 1/80th of final salary for each year of service, or alternatively a combined benefit of 1/80th pension plus 3/80^{ths} lump sum for each year of service (although the amount of lump sum may be capped to be within the Revenue's limit for tax-free cash payments).

The scheme will have a specified retirement age – usually 60 or 65¹. A member can usually take benefits early but is likely to incur a reduction in the accrued benefits to compensate for the longer term that benefits are payable – typically 6% per year early so if an individual takes benefits 5 years early the accrued benefit will be reduced by 30%.

Defined contribution (DC) occupational pension schemes

With a DC or 'money purchase' scheme the employer will specify a rate of contribution, usually expressed as a percentage of salary or total earnings that they will contribute on behalf of a member. The rate of contribution could be flat-rate or could increase with age and/or length of service and/or seniority and/or level of earnings. In addition there might be an element of matching - the employer makes a base level of contribution on behalf of all employees and will increase this where the employee also makes a contribution.

The contributions are invested. Often there is a choice of investment funds – managed, equity, property, gilts, overseas – and with some schemes a choice of investment manager.

At retirement the pension will depend on the accumulated fund, the amount deducted from the fund as a tax-free lump sum (which is usually up to 25% of the total fund) and the annuity rates available at that time if

¹ See ONS (2007) *Occupational Pension Schemes Survey 2006* Table 3.23

an annuity is purchased (which depend on age, sex, health, profile of benefits selected plus the long-term underlying gilt yield).

The employer makes no guarantees regarding the level of benefits that the accumulated fund will provide – if investment returns or annuity rates are worse the resultant pension will be lower whereas conversely if they are better the pension will be higher.

Hybrid pension schemes

Hybrid pension schemes are a catch-all term for schemes that combine elements of DB and DC schemes. This can be done in a number of ways, and is often used as a means for employers to share investment and mortality risk with employees and to increase scheme flexibility.

Such schemes provide a mix of benefits. For example, a ‘nursery scheme’ works like a DC for younger staff, but becomes related to final salary as the member gets older. Alternatives include DC schemes which guarantee that pension benefits will not fall below the level of a final salary scheme and DB schemes which cap the salary used when calculating the final benefit, incorporating a DC top-up for members who earn more than this.

Group personal pensions (GPP) and group stakeholder pensions

In the last few years many employers have introduced a GPP scheme, or more recently a group stakeholder pension. This is in effect a series of individual personal pensions. These schemes are handled by a pension provider following the request of an employer. The main advantage of a GPP compared to an individual arrangement is that charges are likely to be lower. In addition the employer will usually be making a contribution.

Since April 2001 all employers with 5 or more employees have been required to designate a stakeholder provider to which they will make payments deducted from an employees pay if they request. Employers are not required to make any contributions.

Stakeholder pensions are a form of low-charge personal pension that must meet a number of Government standards. The main difference between these and other types of personal pension are that management charges in each year are limited by a maximum charge cap².

² See RN Third tier: Individual pension arrangements

Changes proposed in the Pensions Bill 2007/8

With the introduction of personal accounts in 2012, the Government will set an exemption test for deciding whether an employer-based pension scheme is of a high enough standard to allow the employer to be exempt from auto-enrolling eligible employees into personal accounts. In its December 2006 White Paper, the Government sets out some details about its proposed exemption test for both DB and DC schemes.

Changes proposed in the Budget 2008

To ease the administration of making certain trivial commutation payments, the Government has proposed to change the rules regarding small 'stranded' pension pots in occupational pension schemes. The changes could allow people to take very small pension benefits (a £2,000 limit has been suggested) as lump sums even if an individual has multiple pension funds worth more than the trivial commutation limit of £16,500 in 2008/9³. The changes are designed to ease the administration of certain occupational pension schemes and will probably not apply to personal pensions, since the change may be open to abuse.

³ For more information see Budget 2008 Impact Assessment www.hm-treasury.gov.uk/media/E/5/bud08_impact_147.pdf

Third tier: The Pension Protection Fund

A key feature of Defined Benefit schemes is that the employer is assumed to pay sufficient contributions to ensure that the promised benefits are paid. However, this is not guaranteed.

The Pensions Act 2004 established a Financial Assistance Scheme (FAS) to offer help to members who have lost benefits through an occupational pension scheme that was under funded when it began to wind up and where the employer is insolvent or no longer exists⁴. Members from under funded pension schemes that started winding up between 1 January 1997 and 5 April 2005 are potentially eligible for help from the FAS⁵.

In addition, the Pension Protection Fund (PPF) became operational in April 2005⁶. It has been designed to protect members of certain eligible Defined Benefit occupational schemes and the DB parts of hybrid schemes. The PPF aims to pay some of the pension to members of schemes who lose out when the employer running their scheme becomes insolvent and the pension fund is under funded.

The PPF is managed by an independent Board, who pay compensation, calculate annual levies and oversee the investment of the fund assets.

The PPF intends to pay 100% of the current level of pensions already in payment, and 90% for people not yet receiving a pension. Pensions in payment will be increased each year in line with the Retail Price Index, capped at 2.5%⁷. Compensation payments are subject to an overall cap, which begins at £27,771 (from April 2008) at age 65, and is adjusted depending on an individual's age that the pension comes into payment. These factors may mean that pensions received from the PPF are smaller than members had expected from the original scheme.

Compensation payments will be partly funded by compulsory annual levies contributed by eligible schemes. Since 2006/7, the annual levy comprises an administration levy and a pension protection levy. The

⁴ See DWP *Pension Reform – Financial Assistance Scheme* www.dwp.gov.uk/lifeevent/penret/penreform/fas/

⁵ Extensions to FAS were announced in December 2007. The Pensions Act 2007 provides part of those extensions and the rest will be brought forward in regulations. The changes raise the rate of assistance to 90% of accrued pension at the date of commencement of wind up, revalued to their retirement date. This will be subject to a cap of £26,000 per annum. Assistance will be paid from the scheme's normal retirement age (but not before age 60). To be eligible to get payments from FAS a person needs to be or have been a member of a qualifying pension scheme (or the survivor of such a member). The extensions to FAS remove the age criterion for eligibility. Members of qualifying schemes no longer need to have been within 15 years of their normal retirement age on or before 14 May 2004 to qualify for assistance; the new, more generous level of assistance will be received by all qualifying members, regardless of age. Schemes belonging to solvent employers may now also be eligible.

See www.dwp.gov.uk/lifeevent/penret/penreform/fas/pensions-hoc-statement-17-12-07.pdf

⁶ See www.pensionprotectionfund.org.uk for further information on the PPF

⁷ Relates to service made on or after 6 April 1997 only

administration levy is set in statute and covers the PPF's initial start-up and running costs. The pension protection levy will be set by the PPF Board based on scheme and risk-based factors. Scheme-based factors take into account the level of liability owed to the scheme's members. The risk-based element makes up 80% of the total pension protection levy and relates to a scheme's funding level and the risk of becoming insolvent.

When the PPF takes responsibility of a scheme, it will also acquire the remaining assets of that scheme to help pay for member's compensation.

Third tier: Pension fund regulatory framework

The Pensions Act 2004 introduced a number of changes to the regulation of occupational pension schemes¹.

This included the introduction of the Pensions Regulator which replaced the Occupational Pensions Regulatory Authority in April 2005. This independent body aims to protect members of work-based schemes, to promote good scheme administration practices and to reduce the likelihood of members having to claim compensation from the Pension Protection Fund².

The Regulator has new powers to tackle under funding and will focus its investigative powers on schemes that are at risk from fraud or poor management and administration.

A second role is to reduce the burden of regulation compliance on well-run schemes, allowing them more flexibility.

Most occupational pension schemes are established as trusts, so the pension scheme's assets are managed separately from the sponsoring employer's control. A trustee is a person or company who is responsible for running the pension scheme properly and securing members' benefits.

The role and duties of trustees are set by various laws and acts of Parliament supported by guidance from the Pensions Regulator³.

In addition, the Pensions Act 2004 introduced new regulations on the management and governance of pension schemes.

Two main requirements have now come into force:

- For at least a third (potentially rising to a half at some point in the future⁴) of trustees in every scheme to be nominated and selected by members.
- Obligations of trustees to have knowledge of scheme documentation, pensions and trust law and principles of investing and funding.

One of the responsibilities of trustees is to ensure that their schemes are adequately funded. The Pensions Act 2004 replaced the minimum funding requirement (MFR) with more scheme specific requirements. Additional legislation includes:

¹ Outlined in DWP (2003) *Simplicity, security and choice: Working and saving for retirement action on occupational pensions*

² See www.thepensionsregulator.gov.uk

³ See *Trustees and the Pensions Regulator* www.thepensionsregulator.gov.uk/trustees/index.aspx

⁴ See *Member-nominated trustees and directors* www.dwp.gov.uk/lifeevent/penret/penreform/10_trust.asp

- Trustees to publish a Statement of Funding Principles, setting out funding strategies and strategies to tackle funding deficits.
- Better information for scheme members regarding funding.
- Powers for the Pensions Regulator to resolve disputes between trustees and sponsoring employers.

New provisions under the Pensions Act 2004 have given trustees more flexibility in how they run their schemes, enabling them to adapt their scheme to changing circumstances. Schemes are now able to modify the benefits that members have already accrued as long as they have consulted with the members or are replacing benefits with an actuarial equivalent value.

Greater protection for scheme members has also been factored in. Sponsoring employers are now obliged to consult scheme members before making certain changes to scheme rules. The Pensions Regulator is responsible for enforcing this, with the power to issue fines for non-compliance. Changes to future pension arrangements which would require consultation include closing the scheme to new employees and changes in employer contributions.

Third tier: Preserved rights and protection

The Social Security Act 1973 first introduced protection for those leaving occupational pension schemes before retirement, or early leavers. Prior to then many schemes provided nothing for the job mover. Since then, a number of further provisions have been made to increase the rights of early leavers.

Individuals have to be a member for at least 2 years before they are statutorily entitled to full 'vested' or preserved pension benefits. This is known as the vesting period.

The options available for an individual who leaves employment after the vesting period and with preserved benefits are:

- to leave the deferred pension within the original scheme, or
- to take a transfer value i.e. cash equivalent of the individual member's rights into an individual arrangement such as a personal pension, or
- to take a transfer value to the new employer's pension scheme.

The Pensions Act 2004 introduced new rights for employees who leave after 3 months but before the end of the vesting period. Since April 2006, these employees have two options of:

- a refund of their own contributions, or
- a cash transfer sum to take to another scheme.

If a member leaves a scheme with less than 3 months service – and so is not eligible for a preserved benefit - they will receive a refund of their own contributions, but not any made by the employer¹.

Some pension schemes automatically provide an entitlement to full preserved pension benefits, irrespective of how long the person is a member of the scheme.

¹ This was reduced from 2 years by the 2004 Pensions Act

Third tier: Individual pension arrangements

From 1971 individual pension arrangements were available in the form of retirement annuities. These were then replaced in 1988 with personal pensions. Even though a new retirement annuity contract cannot be bought, regular contributions can still be made to existing contracts. The contribution to these contracts may also be changed.

Personal pensions were only available to individuals while they were self-employed, or were not members of an occupational pension scheme. In April 2001, stakeholder pensions were introduced which widened access further¹, and from April 2006, individual pension arrangements are open to everyone under age 75.

Stakeholder pensions are a form of low-charge personal pension that must meet a number of Government standards. The main difference between these and other types of personal pension are that management charges in each year are limited by a maximum charge cap.

For people who join a stakeholder pension after 6 April 2005, the maximum fund management charge is 1.5% for the first 10 years, thereafter reducing to 1%. For stakeholder plans that were opened before this date, the previous maximum charge of 1% will continue to apply.

Individual pension arrangements are in the form of a money-purchase arrangement - i.e. the contributions, from the individual member or possibly an employer, will be invested and the accumulated fund will be used to provide a tax-free lump sum plus a pension².

Contributions to personal pension schemes are subject to the lifetime and annual allowances³.

An individual can 'trivially commute' and take the full value of their pension benefits as a cash lump sum, providing the individual is between age 60 and 75, and the value of benefits from all the individual's pension arrangements is less than 1% of the standard lifetime allowance (for example, £16,500 in 2008/9). Where the fund being taken as cash has not vested, 25% of the lump sum is tax free⁴, with the balance being taxed as

¹ Between April 2001 and April 2006 members of an occupational pension scheme earning less than £30,000 per annum had an alternative 'concurrency' option. This allowed them to contribute up to £3,600 per annum into a stakeholder or personal pension. The £30,000 limit applied to each employment. So for example, it was possible for someone with more than one employment to have a concurrent pension even if his or her total earnings were above £30,000.

² Prior to 6 April 2006, the tax-free lump sum was limited to 25% of the accumulated fund for personal and stakeholder pensions, whereas for retirement annuities it depended on the annuity rates available at retirement and varied between 18% and 30%

³ See RN on Tax treatment of private pension provision

⁴ Protection exists for individuals who would have been entitled to a larger tax-free lump sum prior to the April 2006 changes

income in the year the individual receives it. The value of any vested benefits being commuted is fully taxable as income in the year the individual receives it.

Third tier: Options for pension withdrawal

With both state pensions and Defined Benefit occupational pension schemes there is some degree of certainty about the level of income an individual will receive once pension payments commence.

In comparison the actual level of income from a Defined Contribution occupational scheme or personal pension arrangement cannot necessarily be accurately predicted in advance. The level of pension is only known on the actual day benefits commence.

Contributions are invested and used to build up a pension fund on behalf of the individual. The ultimate size of this fund will vary, depending on a number of factors including:

- Level of contributions
- Number of contributions
- Timing of contributions
- Underlying investment returns – which in turn depend on the choice of fund manager, the choice of underlying investments – for instance managed, equity, property, gilts, overseas equity, cash – and investment performance until the date the fund is actually cashed
- Charges levied against the fund.

The Finance Act 2004 raised the minimum age that people can withdraw their pension benefits from 50 to 55 on April 6 2010. It also introduces the option of more flexible retirement – people can continue working whilst taking pension benefits – where the occupational scheme rules allow it.

From April 2006, an individual can choose one, or a combination, of three options when they come to withdraw their pension benefits:

- Cash lump sum. Up to 25% of a pension fund can be taken as a tax-free lump sum. This can be taken from any type of pension scheme¹, including protected rights pensions², additional voluntary contributions (AVCs) and free-standing additional voluntary contributions (FSAVCs), provided the scheme rules allow it. The lump sum can be taken at any time after reaching the minimum pension age, but must be taken at the same time as the associated pension benefit.
- Income withdrawal (or ‘drawdown’). This allows an individual to draw an income from their pension fund whilst leaving the remaining fund invested. The minimum and maximum amounts available for withdrawal are set by Government.

¹ For occupational schemes, the amount up to a maximum of 25% that can be taken as a lump sum depends on the scheme rules

² This is the part of a pension fund that was used to contract-out of the additional state pension (SERPS or S2P)

- Annuity. Whether or not a lump sum or income withdrawal has been taken, the remaining fund must then be converted into a pension – or lifetime income – by purchasing an annuity or an alternatively secured pension.

Most annuities purchased are level; once purchased the level of income is then set for the remainder of the individual's life. The cost of the annuity depends on the following factors:

- Long-term interest rates prevalent in the market at that time
- The age and gender of the individual
- The health and lifestyle of the individual - for example those in poor health may be able to get a higher income from their fund
- The type of benefits chosen – for example those increasing in line with RPI, or incorporating a spouse's pension are more expensive
- Expenses of the provider, including any profit margins.

From April 2006 rather than having to buy a lifetime annuity, there is the option of taking a short-term or limited period annuity. This is a fixed-term annuity which provides an income for up to five years whilst the rest of the pension fund remains invested. People will also have the option of taking a Value Protected Annuity (VPA) which allows them to leave their unclaimed pension to their estate should they die early. This 'cash back' is subject to 35% tax. A VPA is only available up to age 75.

A minority of annuities sold are investment-linked, where the payments are linked to the value of the underlying assets. The income, as with all pension income, is taxable as earned income.

If an individual has not taken their pension benefits by the time they reach age 75, they must select either an annuity or take an alternatively secured pension (ASP).

An ASP is a way of drawing an income from a pension fund without having to buy an annuity. The Government has indicated that ASPs were originally introduced for those who have a principled religious objection to the pooling of mortality risk in annuities. Following concerns that ASPs were used by some people to accumulate capital, rather than to provide an income in retirement, the Government has announced a requirement to withdraw a minimum level of income from an ASP.

The minimum income withdrawal will be 55% of the annual amount of a comparable annuity for a 75 year old that could be purchased with the assets of the ASP fund. The maximum income withdrawal is 90%. The income limits are reviewed every year. The income can be changed each year providing it does not exceed the maximum. Also, any lump sum death benefits passed to other scheme members will be taxed at up to 70% and could also be subject to inheritance tax.

Third tier: Tax treatment of private pension provision

The tax treatment of private pension provision is generally expressed as EET – Exempt, Exempt, Taxed. Contributions into a pension fund are exempt from tax, the accumulation of the fund is partially exempt from tax and the majority of the proceeds are taxable.

As a tax-free lump sum can be taken instead of some of the pension income, the final ‘T’ is only partial. The accumulation is also not fully ‘E’. The extent of taxation on the fund accumulation depends on the mix of investments within the pension fund, and the marginal tax rate paid by the individual. The roll up of funds invested directly in bonds, property or cash is completely tax-free. However, since 1997, dividend income from equities has been taxed at a Corporation Tax rate, although capital gains remain tax-free.

Prior to April 2006, contributions to and benefits from pension schemes qualified for tax relief according to limits which were closely related to how much an individual earned¹. There were 8 different regimes, depending on the type of pension scheme in operation.

The Finance Act 2004 introduced measures to simplify the tax treatment of private pensions². From April 2006 there is one single regime, which is the same for all types of pension. The key features of this regime are the introduction of the annual allowance and lifetime allowance, which limit the amount of tax relief received³.

Contributions – ‘Exempt’

Employer contributions are paid gross by the employer and if they are treated by the Inland Revenue as an eligible expense, the employer will get full relief against Corporation Tax. Making pension contributions on behalf of employees has an additional tax advantage for the employer, as employers’ pension contributions are not eligible for National Insurance contributions.

Employee contributions up to the greater of £3,600 and 100% of earnings can be offset against income tax – individuals receive tax relief at their highest marginal rate. In some cases full relief is available immediately whereas in other cases basic rate relief is given immediately and higher rate relief is reclaimed through the end-of-year tax return.

¹ For contributions of more than £3,600 a year

² See Inland Revenue (IR) (2003) *Simplifying the taxation of pension: the Government’s Proposals* www.inlandrevenue.gov.uk/pbr2003/simplifying-pensions.pdf and Her Majesty’s Treasury (HMT) (2004) *Prudence for a purpose: A Britain of stability and strength*, Budget report, www.hm-treasury.gov.uk/budget/budget_04/budget_report/bud_bud04_repindex.cfm

³ See RN Third tier: Overview of private pension provision

From April 2006 there is no limit to the amount of contributions that can be paid into a pension scheme (although some pension schemes may not accept contributions from individuals that do not qualify for tax relief). In any year, if the total contribution made to Defined Contribution arrangements plus the increase in value of benefits under Defined Benefit arrangements for an individual are more than the annual allowance, which is £235,000 in 2008/9, the individual will be taxed at the rate of 40% on the excess.

Fund Accumulation - mainly 'Exempt'

The fund accumulates in a tax-favoured environment – there is no tax on interest or income received gross and no tax on any realised capital gains. However, since 1997 pension funds have not been able to reclaim Advanced Corporate Tax (ACT) on UK dividends⁴.

From April 2006, an individual can build up their pension funds tax-free until the total exceeds the lifetime allowance, which is set at £1.65 million for 2008/9.

Proceeds - mainly 'Taxable'

At 'retirement' up to 25% of the retirement fund can be taken as a tax-free lump sum. The remainder must be used to provide a lifetime income through purchase of an annuity, unsecured pension or alternatively secured pension (ASP). On funds below the lifetime allowance, this pension is taxable as earned income.

Pension funds in excess of the lifetime allowance can still be taken as pension benefit, but they are subject to a different tax rate. When taken as a cash lump sum, the excess is subject to 55% tax. When taken as a pension benefit, the excess is subject to 25% tax, with the income payments taxable as earned income.

Death prior to retirement

On death prior to taking benefits the accumulated fund, plus any insured lump sum death benefit, can be paid out tax-free up to the member's available lifetime allowance. Any additional lump sum would be subject to a tax charge of 55%, payable by the recipients of the benefit. Any widow(er)'s or dependant's pensions are not tested against the member's lifetime allowance but will be taxable as earned income.

⁴ For more information on this see PPI (2005) Briefing Note Number 18 *Is £5 billion being taken from pension funds each year?*

Acknowledgements and contact details

This document is intended to provide a description of the UK pensions system for the purpose of considering pensions policy. It should not be used to make individual pensions decisions.

Every effort has been made to avoid error, but in such a complicated field unintentional errors and omissions may remain. Please contact the PPI if any data appears to be out-of-date, or to suggest additional subjects for Reference Notes.

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The Pensions Policy Institute takes responsibility for remaining errors.
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