

PENSIONS POLICY INSTITUTE

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The Pensions Primer

Updated as at 20 February 2012

The Pensions Primer

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A reference manual by the Pensions Policy Institute

This version of the Pensions Primer reflects the current position of, and legislated future changes to, the UK pension system as at 20 February 2012. Any change in Government policy that may have occurred after that date is not included in this version of 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.

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.

This version of the *Pensions Primer* reflects the current position of the UK pension system as at 20 February 2012. Any changes in Government policy that may have occurred after that day are not included in this version of the *Pensions Primer*.

The *Pensions Primer* uses a box format to explain changes that have been legislated in Acts of Parliament but that are not yet applicable. For example, auto-enrolment into private pensions, which was legislated in the Pensions Act 2008 but will not begin to be introduced until October 2012. Boxes are also used for areas in which the current Coalition Government has announced a change in policy that has yet to be enacted by Parliament, or areas in which it is consulting on future policy changes.

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 income that is more closely related to employees' earnings levels. Tier 2 is less redistributive (from rich to poor) than 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 pension 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 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 the *Primer*.

Chart 1

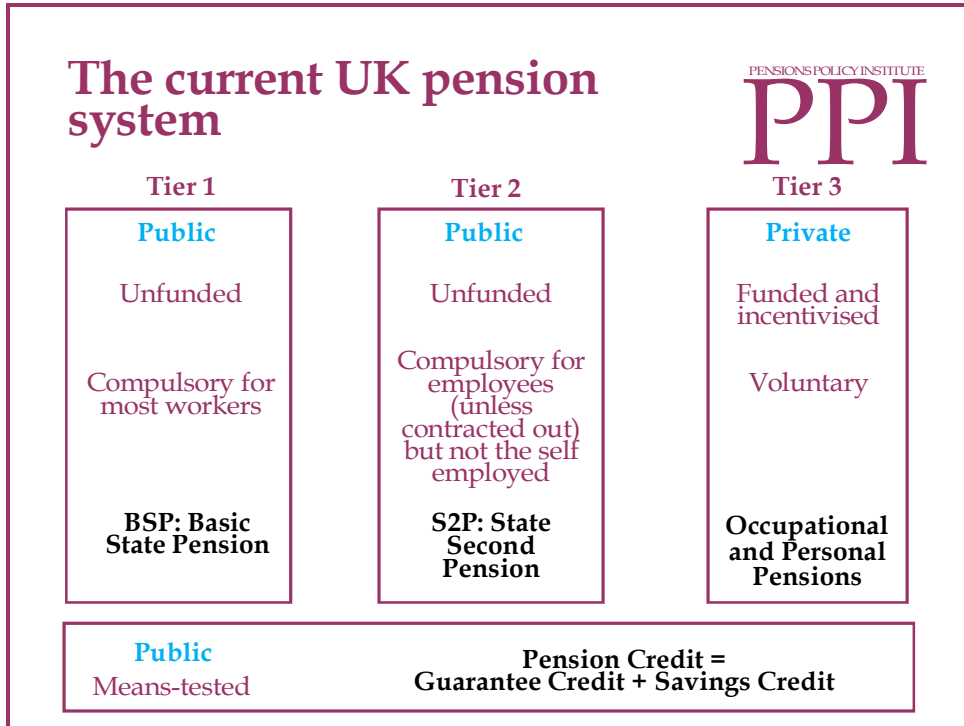
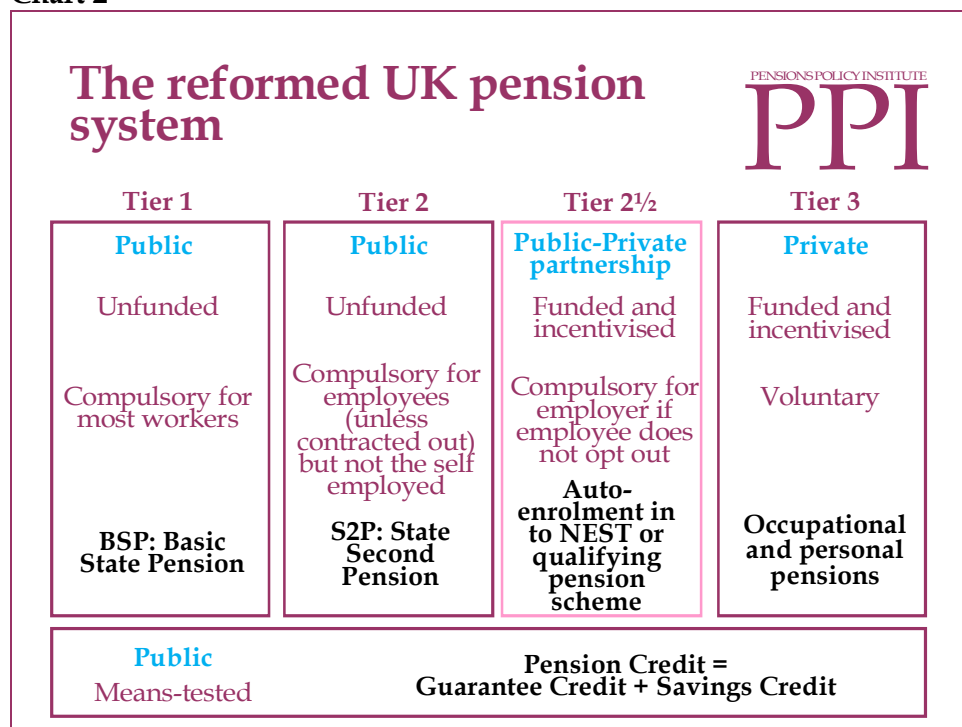


Chart 2 illustrates the changes to private pensions that were legislated following recommendations in the 2005 Pensions Commission Report.¹ It includes an additional tier:

- **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



The next section of the *Pensions Primer* describes each of the tiers of the UK pension system. Subsequent Reference Notes (RN) provide details on many of the points covered.

¹ Pensions Commission (2005) *A New Pension Settlement for the Twenty-First Century*

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 National Insurance contributions made before reaching State Pension Age (SPA).

SPA depends on an individual's birth date. It is currently 65 years of age for men. The Pensions Act 1995 previously legislated for women's SPA to increase from age 60 to 65 between April 2010 and April 2020 in order to match men's SPA. The Pensions Act 2007 then legislated for the SPA to increase for both men and women to 66 between April 2024 and April 2026, then to increase to 67 between April 2034 and April 2036 and finally to increase to 68 between April 2044 and April 2046. However, the Pensions Act 2011 brought forward the planned rise to 65 for women and women's SPA is currently scheduled to rise to 65 by November 2018. The Pensions Act 2011 has also brought forward the rise to age 66 and men and women's SPA will increase to 66 between December 2018 and October 2020.

Bringing forward the rise to 67

The Government has made it clear that it intends to review the timetable for further SPA rises (to age 67 and 68)² and it has recently announced that SPA will rise to 67 between 2026 and 2028.³ The proposal means that people born after 5 April 1961 but before 6 April 1969 will have a SPA of 67. People born after 5 April 1960 but before 6 April 1961 will have a SPA between 66 and 67. This change needs Parliament's approval.

The National Insurance 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 National Insurance contributions, it is not a universal benefit. For people retiring after 6 April 2010, 30 years of National Insurance contributions will be considered to be a full contribution record

BSP is a redistributive, flat-rate state pension payable once an individual reaches State Pension Age. 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 National Insurance contribution record will receive a full BSP of £102.15 from April 2011.⁴ The Government has announced that from April 2012, the BSP will be increased to £107.45.⁵

Claiming the BSP can be deferred until after state pension age in return for an enhancement to the pension. Depending on how long people decide to put off their State Pension, they may choose two options: receiving an enhanced State Pension, or receiving a one-off taxable lump sum and a normal State Pension, provided they put off their claim for at least 12 months.⁶

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 RPI.⁷ 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 relatively to average earnings from 24% of NAE in 1974 to an

² DWP (2010) *A sustainable State Pension: when the State Pension age will increase to 66* www.dwp.gov.uk/docs/cp-nov10-spa-66-full-document.pdf

³ Announced in the Chancellor's Autumn Statement: www.dwp.gov.uk/policy/pensions-reform/latest-news/

⁴ DWP (2011) *Social Security Benefit Up-rating*

⁵ HMT (2011) *Autumn Statement 2011* www.hm-treasury.gov.uk/as2011_index.htm

⁶ See DWP (2011) *State Pension Deferral – Your Guide*, p.10. Available at www.direct.gov.uk/prod_consum_dg/groups/dg_digitalassets/@dg/@en/@over50/documents/digitalasset/dg_180189.pdf

⁷ Since 2004 BSP has been increased by the higher of 2.5% or the RPI

estimated 16% of NAE in 2009.⁸ In the June 2010 Emergency Budget the Coalition Government announced that from April 2011 the BSP will be uprated by the higher of the increase in earnings, the Consumer Prices Index (CPI) or 2.5%. The Government has named this mechanism the “triple lock.”⁹

In addition to the Basic State Pension, 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 (GC), currently payable from age 60 and the Savings Credit (SC), payable from age 65. From 2010, the minimum age for receiving GC is increasing in line with the increases in women’s SPA introduced by the Pensions Act 1995.¹⁰

The GC is the main means-tested benefit currently paid to 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 GC payments are only made to those on low incomes.

Currently, GC provides a minimum income of £137.35 for singles and £209.70 for couples.¹¹ The Government has announced that from April 2012, the GC for singles will be £142.70 and 217.90 for couples.¹² 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 2008/09, between 17% and 29% of households who were eligible for the GC component of Pension Credit did not take up their benefit.¹³

⁸ PPI estimate; also see Department for Work and Pensions (DWP) (2009) Abstract of Statistics 2008 Section 5 - Rates of Benefit www.dwp.gov.uk/asd/asd1/abstract/Abstract2008.pdf and Office for National Statistics (ONS) (2009) Annual Survey of Hours and Earnings 2009 www.statistics.gov.uk/pdfdir/ashed1108.pdf

⁹ See: www.direct.gov.uk/en/Pensionsandretirementplanning/StatePension/DG_188551

¹⁰ The State Pension Credit Act 2002 sets the qualifying age for the Guarantee Credit to be the same as the State Pension Age for women.

¹¹ DWP (2011) *Social Security Benefit Rates*. Available: www.dwp.gov.uk/docs/benefitrates2011.pdf

¹² DWP (2011) *Autumn Statement 2011* www.hm-treasury.gov.uk/as2011_index.htm

¹³ 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) (2010) *Income Related Benefits Estimates of Take-up in 2008-09*, www.statistics.dwp.gov.uk/asd/income_analysis/jun_2010/0809_Publication.pdf

Guarantee Credit was increased in line with increases in NAE for the whole of the last parliament.¹⁴ In the June 2010 Budget, the Chancellor announced an increase for the Guarantee Credit equal to the cash rise in the full Basic State Pension. This amounts to an increase of 3.6%.¹⁵ Guarantee Credit plus the average receipt of Savings Credit provides an income of around 24% of NAE.¹⁶

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 £20.52 per week for a single person and £27.09 per week for a couple from April 2010. The maximum payable rate of savings credit will be frozen at £20.52 and £27.09 until 2014).¹⁷ For every £1 of income received¹⁸ that is above the level of the Savings Credit threshold (£103.15 for single pensioners and £164.55 for couples, in 2011/12) 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 Guarantee Credit level. The Government has announced that from April 2012 the threshold for the Savings Credit will increase to £111.10 for singles and £177.20 for couples.¹⁹

Housing Benefit and Council Tax Benefit are means-tested benefits available to both pensioners and 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.

Not everybody that is eligible claims Housing Benefit. Official estimates show that, in 2008/09, between 13% and 20% of pensioner households who were eligible did not take up their benefit.²⁰

¹⁴ Between May 2005 and May 2010

¹⁵ See House of Commons (2010) *2011 Benefit Up-rating*, p.4. Available at: www.parliament.uk/briefingpapers/commons/lib/research/briefings/snsg-05805.pdf

¹⁶ PPI calculation. The Guarantee Credit level in 2009/10 was £130.00, plus the average amount received in Savings Credit in Aug 2009 was £13.66 (for people not also eligible for the Guarantee Credit component). This adds up to £143.66, which is 24% of NAE in 2009.

¹⁷ See HMT (2010) *Comprehensive Spending Review*, p. 69. Available at www.hm-treasury.gov.uk/spend_index.htm

¹⁸ From ongoing employment, SERPS, Graduated Retirement Benefit, occupational schemes, personal pensions and assumed income from capital savings

¹⁹ HMT (2011) *Autumn Statement* www.hm-treasury.gov.uk/as2011_index.htm

²⁰ Department for Work and Pensions (DWP) (2010), *Income Related Benefits Estimates of Take-up in 2008-09*, www.statistics.dwp.gov.uk/asd/income_analysis/jun_2010/0809_Publication.pdf

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.

According to official estimates, take-up of CTB is relatively low; in 2008/09 between 36% and 44% of pensioner households who were eligible did not take up their benefit.²¹

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

²¹ Department for Work and Pensions (DWP) (2010), Income Related Benefits Estimates of Take-up in 2008-09, www.statistics.dwp.gov.uk/asd/income_analysis/jun_2010/0809_Publication.pdf

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 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)

Some of today's pensioners still receive small amounts of benefit from accrued rights to the **Graduated Retirement Benefit (GRB)**.

The **State Earnings-Related Pension Scheme (SERPS)** is more significant for current pensioners. The original aim of SERPS was to provide a pension of 25% of band earnings. 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 currently based on two earnings bands and two accrual rates.²² For low earners, a flat-rate of S2P pension is guaranteed. Higher earners accrue an additional earnings-related benefit. Disabled people, and some individuals with caring responsibilities, are credited into the flat-rate part of S2P.

²² Earnings between the Lower Earnings Limit and the Upper Accrual Point. Before 6 April 2010, there were three bands accruing benefits at 40% 10% and 20%. Following provisions in the Pensions Act 2007, the former second and third bands have been merged into a single band accruing benefits at 10%. For more details, see page 47

Changes towards a flat-rate S2P

The State Second Pension will be flat-rate in future.²³ From around 2030, the amount of S2P accrual each year should be completely flat-rate but in the meantime, accruals will continue to be dependent to some extent on people's earnings. Provisions have been made for people with caring responsibilities to accrue rights to S2P.

The maximum additional state pension (from a combination of GRB, SERPS and S2P) that can be received per week by a single person is £159.52 (2011/12).²⁴

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 scheme.²⁵ 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 Department, 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.

Abolition of contracting-out from S2P

The Pensions Act 2007 provides for the abolition of contracting-out of the State Second Pension for Defined Contribution occupational and personal pension schemes from April 2012.²⁶ It will still be possible for Defined Benefit schemes to remain contracted-out.

It is often claimed that the UK state pensions system is too complex and that it may be difficult for people to understand the state benefits to which they are entitled to and how best to plan for their retirement.

²³ Provisions for this were legislated for in the Pensions Act 2007.

²⁴ www.direct.gov.uk/en/Pensionsandretirementplanning/StatePension/DG_183780

²⁵ 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

²⁶ Announced by Angela Eagle, Minister of State for Work and Pensions at the time, in a written statement on 12 March 2010 Hansard HC 12 Mar 2010 : Column 36WS.

www.publications.parliament.uk/pa/cm200910/cmhansrd/cm100312/wmstext/100312m0001.htm

Consultation on State Pension Reform

The Government has issued a Green Paper to consult on the introduction of significant reforms that would change the current structure of the first and second tier of the state pension system.²⁷

The Government is proposing to implement one of two possible reforms:

- an acceleration of the reforms legislated for in the Pensions Act 2007, so that the state pension would evolve into a two-tier flat-rate structure by 2020 instead of 2030;
- a more radical reform towards a single-tier flat-rate pension set above the current level of the BSP plus the maximum Guarantee Credit element of Pension Credit (estimated at £140 per week, in 2010 earnings terms).

Under the first option, the system would retain its two tier structure albeit with a simplified structure for S2P accrual, which may help people to better understand their state pension entitlement.

Under the second option, the state second pension (S2P) would be eliminated and everyone with at least 30 years of national insurance contributions would qualify for the new single-tier pension, estimated at £140 per week. A minimum of 7 qualifying years of national insurance contributions would be necessary for individuals to be entitled to the single-tier pension, albeit on a reduced rate.

The elimination of S2P, while making the system more simple, would also lead to the elimination of contracting-out and, thus, scheme sponsors would no longer receive national insurance contributions rebates. This could impact on the running costs of defined benefit (DB) schemes, which have been under pressure since the last decade due partly to increasing longevity risks.

²⁷ See DWP (2011) *A State Pension for the 21st Century*. Available at: www.dwp.gov.uk/docs/state-pension-21st-century.pdf

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.

Many private pension arrangements are **employer-sponsored**. The employer link may be very strong; for example, the employer funds and administers an occupational scheme. 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 a 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 provide income for the remainder of an individual's life. Subject to limits, part of the fund may also be paid out as a tax-free lump-sum.

Individual contributions to private pension schemes 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 schemes.

In **Defined Benefit** schemes, the benefit received upon retirement is determined by a formula that sets the levels of benefits to be offered, which are usually linked to final or career average salary levels.

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 65,²⁸ but a member can usually retire early with a reduction in 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.

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 employee.²⁹

To increase the security of Defined Benefit occupational pension schemes, the government has introduced a 'Pension Protection Fund', which became operational in April 2005. This will pay a minimum level of pension even if an employer becomes insolvent and the pension fund is underfunded.³⁰

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 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.

²⁸ See ONS (2009) *Occupational Pension Schemes Survey 2008* Table 2.19 www.statistics.gov.uk/downloads/theme_population/Occ-Pension-2008/OPSS_Annual_Report_2008.pdf

²⁹ See PPI Briefing Note Number 2 *The shift from Defined Benefit to Defined Contribution*

³⁰ See Pension Protection Fund www.pensionprotectionfund.org.uk/ and HM Government (2004) Pensions Act 2004 www.opsi.gov.uk/acts/acts2004/20040035.htm

Contracting-out of Second State Pension

Currently, both DB and DC schemes can be used to contract-out of S2P, although the Pensions Act 2007 abolishes contracting-out in DC schemes from April 2012.³¹

Additional Voluntary Contributions

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 means.³²

Personal Pensions

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

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

Stakeholder pensions are a form of low-charge DC 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 penalties.³³

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.

³¹ Announced by Angela Eagle, former Minister of State for Work and Pensions, in a written statement on 12 March 2010 Hansard HC 12 Mar 2010 : Column 36WS

³² 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.

³³ See RN Third tier: Individual pension arrangements

Auto-enrolment into pension schemes from 2012

The previous Labour Government acted on the recommendations of the Pensions Commission that reported in 2005,³⁴ and legislated in the Pensions Act 2008 for the introduction of automatic enrolment into private pensions for all employees between 22 and state pension age to be phased in from October 2012. Employees will have the right to opt-out. The Pensions Act 2011 sets the earnings threshold above which every worker should be auto-enrolled at £7,475 in 2011/12.³⁵ Contributions become payable on band earnings over £5,715 in 2010/11 and up to a limit of £38,185.³⁶

Upon auto-enrolment, minimum total contributions of 8% of earnings within designated bands will be paid to a qualifying pension scheme, with a minimum 3% from the employer. The employee and the Government could also contribute. The specific employee contribution rate will depend on the employer contribution. The Government contribution will be proportional to the employee contribution, as it is calculated as tax relief on employee contribution.³⁷ If the employer decides to contribute the legal minimum of 3% of band earnings, then the employee will have to contribute 4% and the Government will contribute 1% through tax relief.³⁸ However, it will be up to employers to decide whether they want to contribute the legal minimum or more.

National Employment Savings Trust (NEST)

The Pensions Act 2008 also provides for the introduction of a new pension saving scheme of low-cost, individualised pension savings accounts from October 2012 called NEST (National Employment Savings Trust). Employers who do not offer an occupational pension or a stakeholder or other qualifying pension scheme will be able to auto-enrol their employees into NEST, provided that the employee's earnings are above the current proposed auto-enrolment threshold of £7,475 in 2011/12. Employees with earnings below this level will be permitted to opt in to the scheme. There will be a contributions limit of £4,300 a year (in 2010/11 terms).³⁹

NEST will have a low-charging structure. Members will pay an Annual Management Charge of 0.3% of the fund per year. However, for the first few years of operation NEST members will also pay a 1.8% charge on contributions in order to fund NEST's start-up costs.⁴⁰

³⁴ See Pensions Commission (2005) *A New Pension Settlement for the Twenty-First Century*, p.

³⁵ This is aligned with the income tax threshold.

³⁶ See DWP (2011) *Automatic Enrolment and Workplace Pension Reform – The Facts*, p.9 Available at: <http://www.dwp.gov.uk/docs/auto-enrol-and-wpr-the-facts.pdf>

³⁷ The tax relief may be higher for those people who pay higher-rate tax

³⁸ The tax relief may be higher for those people who pay higher-rate tax

³⁹ Equivalent to £3,600 in 2005/2006 earnings terms. See Johnson, P. Yeandle, D. Boulding, A. (2010) *Making automatic enrolment work: A review for the Department for Work and Pensions*, p.19 www.dwp.gov.uk/docs/cp-oct10-full-document.pdf

⁴⁰ Announced on 24 November 2010. *Press Release: NEST Corporation Sets NEST Charging Level*. www.nestpensions.org.uk/documents/NEST_Corporation_sets_NEST_charging_level.pdf

Staging and phasing of auto-enrolment

Automatic enrolment will start in October 2012 with large employers enrolling their eligible employees in a staged process. The Government has recently announced that medium and small employers will be given additional time to automatically enrol their eligible employees.⁴¹

Large employers with 250 or more employees will not face any change in the date they are due to enrol their eligible employees and they will begin to do so from 1 October 2012 to 1 February 2014.

Medium sized employers with 50 to 249 employees will have automatic enrolment dates between 1 April 2014 and 1 April 2015. This means that the implementation dates of some of these employers will be up to nine months later than originally planned.

Small employers with less than 50 employees will have automatic enrolment dates from 1 June 2015 to 1 April 2017.

New employers setting up business from 1 April 2012 and up to and including 30 September 2017 will have automatic enrolment dates between, and including, 1 May 2017 and 1 February 2018. So all employers will be automatically enrolling their eligible employees from 1 February 2018. Any new employer setting up business from 1 October 2017 onwards will be required to comply immediately if paying earnings which attract PAYE deductions in respect of any worker.

Minimum employer contributions will be phased-in starting at a minimum 1% of band earnings in October 2012. The Government announced that the increase in minimum employer contributions from 1% to 2% will now begin on 1 October 2017. Contributions will then increase to 3% from 1 October 2018.

Tax Simplification

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 rules.⁴² 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 joining.⁴³

⁴¹ DWP (2012) "New timetable clarifies automatic enrolment starting dates" dwp.gov.uk/newsroom/press-releases/2012/jan-2012/dwp010-12.shtml

⁴² 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

⁴³ Although exemptions to the lifetime allowance are available to protect existing rights

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 annual allowance (AA). The AA for 2011/12 is £50,000. Contributions above this level are taxed at an individual's tax rate.

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 (£1.8 million for 2011/12), an additional tax charge is applied.

Changes to Tax Relief: Annual Allowance (AA)

The Coalition Government announced changes to tax relief, which were introduced in the draft Finance Bill 2011.⁴⁴ The changes, which became effective from 6 April, mean that the AA has been reduced to £50,000. Individuals will be able to offset any contributions in excess of the AA against unused allowances from the previous 3 years. Contributions in excess of the AA will be taxed at a tailored charge to recoup the full marginal relief rate that the individual has benefited from.⁴⁵

Changes to Tax Relief: Lifetime Allowance (LTA)

The Coalition Government also announced changes to the lifetime allowance that will become effective from 6 April 2012.⁴⁶ From that date the LTA will be reduced from £1.8 million to £1.5 million. Savings above this level will be taxed at a rate of 25%. The AA and LTA are expected to remain constant until 2015/16.

Withdrawing Retirement Income

The Finance Act 2004 raised the minimum age at which people can withdraw their pension benefits from 50 to 55 from 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 the trivial commutation limit (currently £18,000),⁴⁷ it is possible to 'trivially commute' and take the whole fund as a lump sum, with 25% being tax-free.

⁴⁴ The changes were initially announced in the 2010 Comprehensive Spending Review.

⁴⁵ See HMT (2010) *Restricting pensions tax relief through existing allowances: a summary of the discussion document responses*, p. 25.

⁴⁶ The changes were initially announced in the 2010 Comprehensive Spending Review.

⁴⁷ The trivial commutation has previously been set at 1% of the Lifetime Allowance (currently £1.8m) however it has been decoupled from the lifetime allowance from 2012, and will not change before then. See HMT (2010) *Restricting pensions tax relief through existing allowances: a summary of the discussion document responses*, p. 26.

- Income withdrawal or 'drawdown'. Also known as an unsecured pension (USP).
- Annuity. An insurance product that pays an income from the date of purchase until the date of death.⁴⁸

Until June 2010 any individual with private pension savings who had not opted for an annuity by the time they reached the age of 75, was required to begin withdrawing their pension benefits, either by purchasing an annuity or by the additional option of an alternatively secured pension (ASP). An ASP allowed some of the pension to be withdrawn as an income, whilst the remaining sum continued to be invested for future income.⁴⁹ The low withdrawal limits and high taxes applied to ASPs meant that for many people, purchasing an annuity was the only realistic method of accessing their pension savings.

Elimination of the requirement to purchase an annuity by age 75

In June 2010, The Coalition Government announced the elimination of the requirement to purchase an annuity by age 75 from April 2011.⁵⁰ From 6 April 2011, the legislation put in place allows people over age 55 with private pension savings a choice of doing one or a combination of the following options:

- purchasing an annuity;
- investing their fund for their entire retirement in an income drawdown account (while taking an income from it, capped at 100% of an equivalent annuity);
- withdrawing the rest of their fund flexibly provided that individuals can demonstrate a secured guaranteed lifetime pension income of at least £20,000 per year.⁵¹

⁴⁸ An annuity insures against an individual's money running out because he or she lives longer than expected

⁴⁹The previous Labour Government intended ASPs to be used by a small group of people who had a principled religious objection to buying an annuity, however, ASPs were also used by some people to avoid having to purchase an annuity. From April 2007 new rules were brought in with the aim of preventing people from using ASPs to pass on tax-favoured funds on or before their death.

⁵⁰ Announced in the June 2010 Emergency Budget. See HMT (2010) *Budget 2010*, p.35.

⁵¹ See HMT (2011). *Removing the Effective Requirement to Annuitise by Age 75*, p.2. Available at: www.hm-treasury.gov.uk/d/pensions_annuitisation.pdf

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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 (Chart 3). Any tax year in which an individual makes, or is credited with making, 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 £139 per week. If they earn less than the PET but more than the 'Lower Earnings Limit' (LEL) of £102 per week, then they do not make Class 1 contributions but are credited for the BSP.⁵² The self-employed make flat-rate Class 2 contributions of £2.50 per week.⁵³ Class 3 voluntary contributions, of £12.60 per week, are paid by those who wish to protect their entitlement and have not paid enough Class 1 or Class 2 contributions. Class 3 payments must generally be made within 6 years from the end of the tax year for which payment is being made.⁵⁴

Chart 3

Main Classes of National Insurance Contributions (NICs)		Who pays this class	What this entitles people to
Class 1	Paid by employers at a rate of 13.8% and employees aged between 16 and SPA who earn over the Primary Earnings Threshold (PET) at a rate of 12% and at a rate of 2% for earnings over the Upper Earnings Limit (UEL). People who earn at or above the Lower Earnings Limit (LEL) (currently £102 per week) but below the PET (currently £139 per week) are not required to pay but are treated as having paid NICs.		Each qualifying year counts towards an individual's pension entitlement and is used to calculate how much Basic State Pension (and Second State Pension) they will receive. People who earn below the LEL do not accrue entitlement to Basic State Pension
Class 2	Paid by people who are self employed at a fixed rate, people on low earnings can apply for exemption		Each Class 2 contribution is treated as one week of earnings at the LEL.
Class 3	Voluntary contributions people can pay in order to fill gaps in their contribution record.		Can fill in gaps of full or partial years in order to make those years qualifying years for State Pension entitlement
Class 4	Additional contributions paid by self-employed people (as well as Class 2 NICs) at a rate of 8% on profits between the Lower Profits Limit and Upper Profits Limit (UPL) and 1% on profits above the UPL		Does not count towards qualifying years

There are also 19 activities that can credit someone into the Basic State Pension. Credit will be given if, for instance, an individual is entitled to

⁵² From April 2011

⁵³ Special Class 2 rates apply for fishermen and volunteer development workers. These are £3.15 and £5.10 respectively. The self-employed also make class 4 contributions, which are earnings-related but do not affect BSP entitlement.

⁵⁴ People were permitted to make back payments for more than 6 years if the payments were for the tax years 1996/1997 through to 2001/2002, and these payments were made by April 2009 or April 2010 depending on when people reach SPA. For detailed explanation see: www.hmrc.gov.uk/nic/class3.htm

Statutory Sick Pay or Statutory Maternity Pay, Jobseekers 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 64.⁵⁵

No qualifying years are earned and no credit is earned if a married woman or widow is paying reduced-rate NI contributions.⁵⁶

Home Responsibilities Protection (HRP) was introduced in 1978 and, for people reaching SPA before April 2010, reduced the number of years of contribution required to secure a full BSP. Protection was given for those complete tax years where an individual was caring for children or an older or a disabled person.

As a result of 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. However, people reaching State Pension Age before 6 April 2010 will still need to have contributed for 39 or 44 years to qualify for a 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 under a credit system is more generous and simplifies the way entitlement is calculated. For example, a person with 5 qualifying years and 10 years of HRP would, under the reduction system receive 25% of the full state pension; calculated as 5 years out of their 20 (i.e. 30 - 10 HRP) required years. Under a credit system the same person would receive 50% of the full state pension; calculated as 15 (5 + 10 credits) years out of their required 30 years.

⁵⁵ 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

⁵⁶ 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.

From 2010, carers 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 means 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 are 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).

From 2011, grandparents of working age who care for grandchildren for 20 hours or more per week will also be eligible to receive caring credits which count towards their BSP entitlement.⁵⁷

People reaching SPA before 2010

For men who reached State Pension Age before 6 April 2010, the full BSP of £102.15 is payable with at least 44 qualifying years from a maximum of 49. For women born prior to 6 April 1950 the full BSP is payable with at least 39 qualifying years from a maximum of 44.

A proportionate benefit is payable if the number of qualifying years is less than that needed for the maximum. For example, a woman who retired before 6 April 2010 with a 30 year contribution record currently receives a BSP of £78.58 per week $((30/39) * £102.15)$.⁵⁸ However, if the number of qualifying years at retirement was less than 25% of the amount required for a maximum BSP then no BSP benefit is payable.

If a woman⁵⁹ cared for a child until the child reached age 16 the requirement for a maximum BSP would reduce from 39 qualifying years to 24. HRP did not give complete protection as it did not reduce the number of qualifying years required for a full BSP below 20 years.

Changes in the Pensions Act 2007 and the 'cliff-edge'

People who reached State Pension Age before 6 April 2010 still needed to have contributed for 39 or 44 years to qualify for a full Basic State Pension.

This sudden drop off in qualifying years, known as the 'cliff-edge', was perceived by some stakeholders as unfair, especially to women. After much debate in Parliament, provision was introduced under the *Pensions*

⁵⁷ See Budget 2009 speech, www.hm-treasury.gov.uk/bud_bud09_speech.htm

⁵⁸ Assuming no Home Responsibilities Protection is awarded

⁵⁹ Although most recipients are women, HRP is unisex - it is available to the person to whom child benefit is payable

Act 2008 to enable certain people reaching SPA between 6 April 2008 and 5 April 2015 to buy an additional 6 years of voluntary Class 3 NICs for tax years after 1975/76.⁶⁰

Example⁶¹

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 SPA.

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 childcare credit only applies while the child is below age 12, Mary receives 12 years of credit. In addition, she will have been credited with minimum contributions for the tax years in which she was 16, 17 and 18 and in full time education (although she was in full time education for 6 years, the maximum credit for full time education is 3 years).

Mary has 35 years of credits (20 years of work + 3 years of full time education + 12 years of childcare credit) and is therefore eligible for a full BSP since the number of qualifying years required for a full BSP is 30. This amounts to £102.15 in 2010/11.

Had there been no childcare credit Mary would have received only 77% (23/30) of BSP, or £78.32 per week.

This example assumes Mary reaches state pension age after 6 April 2010, when the relevant changes in the Pensions Act 2007 come into effect.

If Mary had retired before 6 April 2010 then she would have received a pension of 96% (23/24) of the full BSP (20 years of work + 3 years of full time education, 39 years requirement – 15 HRP years for childcare). This is: £102.15 x 23/24 = £97.89.

⁶⁰ www.parliament.uk/briefingpapers/commons/lib/research/briefings/snbt-03111.pdf

⁶¹ 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 widows of men who were over 65 on 5 July 1948
- Category D is non-contributory and is payable to people over age 80 who satisfy certain residency conditions and fail to qualify for a category A or B pension, or receive less than the non-contributory rate
- 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.

Recent changes in eligibility criteria for Category A pension⁶²

For people reaching state pension age before 6 April 2010 and for those claiming bereavement benefits, past 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 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.

Parents and carers are also allowed 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.

⁶² The changes described in this section were legislated in the Pensions Act 2007 and in the Budget 2009.

From 2011 grandparents of working age who care for grandchildren for 20 hours or more per week will also be eligible to build up entitlement to a category A pension through credits.⁶³

Category B pension

This is contributory and is based solely on a spouse's or civil partner's qualifying years and earnings. Previously it was only payable to married women, widows and widowers but from 6 April 2010 both men and women are able to claim BSP based on their spouse's or partner's NI record if this is better than their own.

Changes to eligibility for Category B pension⁶⁴

From 6 April 2010 people can claim category B pension even if their spouse has deferred their own category A claim. Changes also allow the spouse or partner of a carer to build up entitlement to an associated category B pension.

As a result of these changes, 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.

Prior to April 2010, if the wife was under state pension age and the husband was over state pension age and claiming the BSP, then the husband could have been eligible for an adult dependency increase to his state pension in respect of the wife, equal to 60% of the full BSP.

Abolishment of Adult Dependency Increases

Adult dependency increases for dependants under state pension age were abolished from 6 April 2010.⁶⁵ Provisions will be made to protect entitlements up to 5 April 2020.

Example (under the rules currently in place)

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 £102.15 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

⁶³ See Budget 2009 speech, www.hm-treasury.gov.uk/bud_bud09_speech.htm

⁶⁴ Legislated in the Pensions Act 2007

⁶⁵ Legislated in the Pensions Act 2007. See details at: www.dwp.gov.uk/docs/state-pensions-changing-glossary.pdf. See also: www.direct.gov.uk/en/Pensionsandretirementplanning/StatePension/DG_069498

she can claim an additional £31.20 per week (category B) based on George's record giving a total weekly income of £163.35 for the couple.

Once Elizabeth reaches 60 the full £163.35 would be payable to the couple even if she continues to work. From that date £102.15 would be payable to George and £61.20 would be payable to Elizabeth (£163.35 - £102.15 = £61.20).

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 widows of men who were over 65 in July 1948. Approximately 60 category C pensions were still in payment as of November 2007.⁶⁶

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 it amounts to £61.50 in 2011/12. If the person is on a reduced pension, he/she will receive the difference between £61.50 and the reduced BSP.⁶⁷

Age addition

An age addition of 25p per week 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.

⁶⁶ PPI estimate based on DWP statistics available through tabulation tool: www.dwp.gov.uk/asd/tabtool.asp

⁶⁷ See DWP (2011) *Benefits Uprates* www.dwp.gov.uk/docs/benefitrates2011.pdf

First tier: State pension age

The State Pension Age (SPA) is the minimum legal age at which a basic state pension can be claimed. The SPA depends on an individual's birth date. It is currently 65 years for men. Until 5 April 2010 SPA for women was 60 years. Under the provisions of the Pensions Act 1995 and the Pensions Act 2011, SPA for women is increasing from April 2010 in a series of steps to age 65 by November 2018. Following provisions in the Pensions Act 2011, the SPA for women increases faster to 65 between April 2016 and November 2018 than in the Pensions Act 1995 and the SPA for both men and women increases to 66 between December 2018 and October 2020.

These changes apply to women born on or after 6 April 1950. For those women born on or after 6 December 1953 the SPA will be 65. Women born between April 1950 and 5 April 1953 will have a SPA that is approximately 1 extra month for each month (or part month) they were born after 6 April 1950. In practice this means that their SPA is increased two months by each month (or part of month) they were born after 6 April 1950. Women born between 6 April 1953 and 5 December 1953 will have their SPA increase by four months for each month (or part of month) they were born after 6 April 1953.

Between May 2010 and October 2020 all women 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 relevant month.

The Pensions Act 2007 legislated for the increase in SPA for both men and women to 66 between April 2024 and April 2026. However, the Pensions Act 2011 brought forward the increase in SPA from 65 to 66 to occur by October 2020. Thus, by October 2020 the SPA for both men and women will be 66 years; this is five and a half years earlier than under previous legislation.⁶⁸

For individuals born after 5 November 1954, their SPA will be at least 66 years. The Pensions Act 2007 also legislated further increases in SPA to 67 between 2034 and 2036 and to 68 between 2044 and 2046.

⁶⁸ For specific information on the SPA under the new rules depending on the date of birth, check The Pensions Advisory Service State Pension Age calculator: www.pensionsadvisoryservice.org.uk/state-pensions/state-pension-age-calculator.

The DWP is currently updating its IT systems to provide SPA forecasts to people affected by the changes in the Pensions Act 2011. These changes affect women born on or after 6 April 1953 and men born on or after 6 April 1951. Women and men born before these dates are not affected. In the meantime, the Department has put in place an alternative product for this group of people, called State Pension Statement, which provides individuals the date on which they reach their State Pension age under the new rules, along with an estimate of their State Pension, based on their own National Insurance Contributions record as it currently stands. More information is available at www.direct.gov.uk/pensionforecast.

Under this legislation:

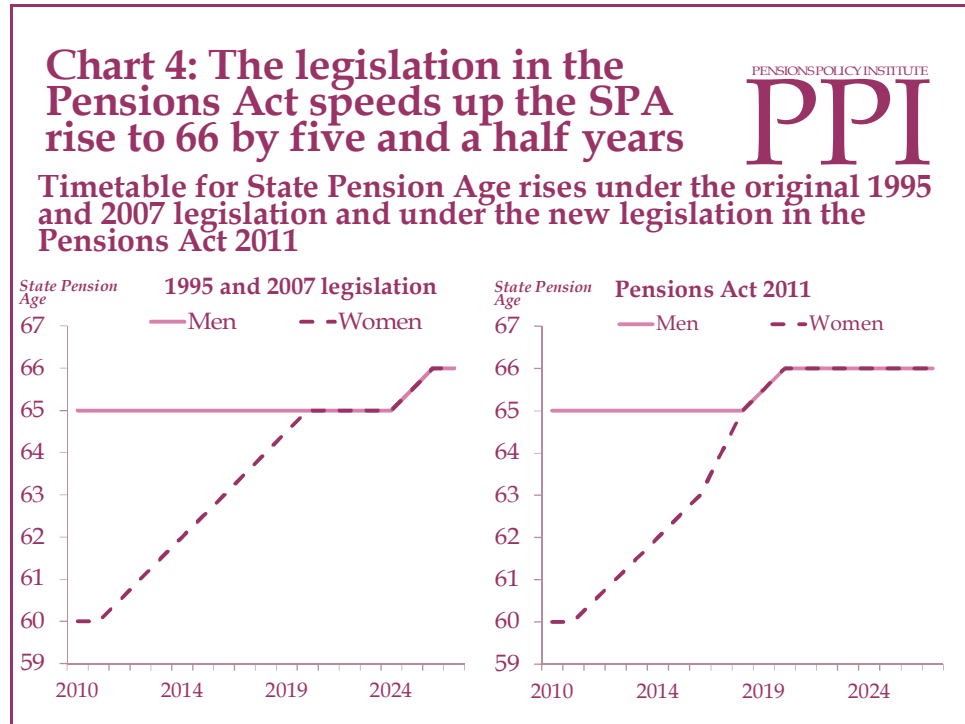
- People born between 6 April 1968 and 5 April 1969 will reach SPA between 66 years and 67 years of age depending on when in that period they were born.
- People born between 6 April 1969 and 5 April 1977 will all reach SPA at 67 years.
- People born between 6 April 1977 and 5 April 1978 will all reach SPA between 67 and 68 years. For those born thereafter, SPA will be 68 years.

Table 1 compares the effects of the increases in SPA for women under the Pensions Act 2011 provisions, compared to previous legislation, according to their birth date. Chart 4 does the same but also including the changes in men’s SPA.

Table 1: Comparing the effects of previous and Pensions Act 2011 provisions on womens’ SPA

Date of Birth	Pensions Act 1995		Pensions Act 2011	
	State Pension Date	State Pension Age	State Pension Date	State Pension Age
6 March 1950 – 5 April 1950	6 April 2010	60 yrs 1 mth – 60 yrs	6 April 2010	60 yrs 1 mth – 60 yrs
6 April 1950 – 5 May 1950	6 June 2010	60 yrs 2 mths – 60 yrs 1 mth	6 June 2010	60 yrs 2 mths – 60 yrs 1 mth
6 May 1950 – 5 June 1950	6 Aug 2010	60 yrs – 3 mths – 60 yrs 2 mths	6 Aug 2010	60 yrs – 3 mths – 60 yrs 2 mths
6 March 1953 – 5 April 1953	6 April 2016	63 yrs 1 mth – 63 yrs 0 mths	6 April 2016	63 yrs 1 mth– 63 yrs 0 mths
6 April 1953 – 5 May 1953	6 June 2016	63 yrs 2 mths – 63 yrs 1 mth	6 July 2016	63 yrs 3 mths – 63 yrs 2 mths
6 October 1953 – 5 Nov 1953	6 Jun 2017	63 yrs 8 mths – 63 yrs 7 mths	6 July 2018	64 yrs 9 mths – 64 yrs 8 mths
6 Nov 1953 - 5 Dec. 1953	6 Aug 2017	63 yrs 9 mths – 63 yrs 8 mths	6 Nov 2018	65 yrs – 64 yrs 11 mths
6 Dec 1953 – 5 Jan 1954	6 Sept 2017	63 yrs 10 mths – 63 yrs 9 mths	6 March 2019	65 yrs 3 mths – 65 yrs 2 mths
6 Jan 1954 – 5 Feb 1954	6 Nov 2017	63 yrs 11 mths – 63 yrs 10 mths	6 May 2019	65 yrs 4 mths – 65 yrs 3 mths
6 April 1954 – 5 May 1954	6 May 2018	64 yrs 1 mths – 64 yrs	6 Nov 2020	65 yrs 7 mths – 65 yrs 6 mths
6 May 1954 to 5 June 1954	6 July 2018	64 yrs 2 mths – 64 yrs 1 mth	6 Jan 2020	65 yrs 8 mths – 65 yrs 7 mths
6 Aug 1954 to 5 Sept 1954	6 Jan 2019	64 yrs 5 mths – 64 yrs 4 mth	6 July 2020	65 yrs 11 mths – 65 yrs 10 mths
6 Sept 1954 to 5 Oct 1954	6 Mar 2019	64 yrs 6 mths – 64 yrs 5 mth	6 Sept 2020	66yrs – 65 yrs 11 mths
6 Oct 1954 to 5 Nov 1954	6 May 2019	64 yrs 7 mths – 64 yrs 6 mth	66 th birthday	66yrs

Chart 4: Comparing the effects of previous and Pensions Act 2011 provisions on SPA for both men and women.



Bringing forward the rise to 67

The Government has made it clear that it intends to review the timetable for further SPA rises (to age 67 and 68)⁶⁹ and it has recently announced that SPA will rise to 67 between 2026 and 2028.⁷⁰ The proposal means that people born after 5 April 1961 but before 6 April 1969 will have a SPA of 67. People born after 5 April 1960 but before 6 April 1961 will have a SPA between 66 and 67. This change needs Parliament’s approval.

⁶⁹ DWP (2010) *A sustainable State Pension: when the State Pension age will increase to 66* www.dwp.gov.uk/docs/cp-nov10-spa-66-full-document.pdf

⁷⁰ Announced in the Chancellor’s Autumn Statement: www.dwp.gov.uk/policy/pensions-reform/latest-news/

First tier: Deferral of state pensions

Individuals can choose to defer⁷¹ the commencement of their BSP in return for an enhanced pension, through the award of increments, or as a one-off lump sum.⁷²

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, individuals 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 income.⁷³ Because of the 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 any extra interest over and above what could be gained from claiming the pension and investing it. If the pension could be taken and invested at a higher rate than the 2% above the Bank of England base rate, it would suggest that deferring may not be cost effective.

⁷¹ See DWP (2010) *State Pension Deferral, Your Guide*. Available at: www.direct.gov.uk/prod_consum_dg/groups/dg_digitalassets/@dg/@en/@over50/documents/digitalasset/dg_180189.pdf

⁷² 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.

⁷³ Even if some of the lump sum would normally have fallen in a higher tax band

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 rise 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 was 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 year for single pensioners and £160 for married couples. The actual annual increases in the BSP in 2004 were £111.80 and £179.40 per year, for single pensioners and married couples respectively.

Although the purpose of 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 (Table 2). Under previous policy BSP would have continued to erode relative to NAE until at least 2012.⁷⁴

Changes to BSP uprating

From April 2011 the BSP is uprated by the higher of 2.5%, earnings or prices (a mechanism known as the “triple lock”). The Consumer Price Index (CPI), rather than the Retail Price Index (RPI) is used to consider price inflation. Table 3 shows the impact of the new mechanism by comparing the possible uprating under the triple lock.

⁷⁴ Assumptions – RPI increases each year by 2.87%. NAE increases each year by 2% above the RPI.

Table 2: Historical uprating of BSP in relation to National Average Earnings

	BSP - Weekly Amount	Adjusted to April 2010 prices	Weekly National Average Earnings	BSP as a percentage of NAE
October 1972	6.75	67.45	32.00	21.1%
July 1974	10.00	80.12	41.70	24.0%
November 1977	17.50	82.08	70.20	24.9%
November 1979	23.30	86.16	89.60	26.0%
November 1982	32.85	88.54	136.50	24.1%
April 1987	39.50	86.46	198.90	19.9%
April 1992	54.15	86.92	304.60	17.8%
April 2000	67.50	88.42	425.10	15.9%
April 2001	72.50	93.32	449.70	16.1%
April 2002	75.50	95.74	472.10	16.0%
April 2003	77.45	95.23	487.10	15.9%
April 2004	79.60	95.50	498.20	16.0%
April 2005	82.05	95.41	516.40	15.9%
April 2006	84.25	95.53	534.90	15.8%
April 2007	87.30	94.70	549.80	15.9%
April 2008	90.70	94.43	574.30	15.8%
April 2009	95.25	100.34	587.30	16.2%
April 2010	97.65	97.65	598.30	16.3%

Table 3: Projected uprating of BSP under the previous (RPI based) and reformed (triple locked) systems

Tax Year	Weekly National Average Earnings ⁷⁶ (Projected)	Previous system (increasing with prices)		Reformed system (following the Triple Lock assumption) ⁷⁵	
		BSP - Weekly Amount (Projected)	Projected BSP as a percentage of NAE	BSP - Weekly Amount (Projected)	Projected BSP as a percentage of NAE
April 2011	£610	£102.15	16.8%	£102.15	16.8%
April 2013	£647	£108.75	16.8%	£110.70	17.1%
April 2018	£805	£127.10	15.8%	£138.80	17.2%
April 2023	£1,003	£146.40	14.6%	£175.10	17.4%
April 2028	£1,250	£168.60	13.5%	£221.00	17.7%
April 2033	£1,558	£194.20	12.5%	£278.80	17.9%
April 2038	£1,942	£223.70	11.5%	£351.80	18.1%

Sources

Office for National Statistics (ONS) (2009 and previous editions) *Annual survey of hours and earnings (ASHE) - 2009 Results*

www.statistics.gov.uk/StatBase/Product.asp?vlnk=15313

Office for National Statistics (ONS) (2010) *Retail Prices Index: monthly index numbers of retail prices 1948-2010*

www.statistics.gov.uk/STATBASE/Product.asp?vlnk=2176

⁷⁵ The Triple Lock is assumed to increase by 4.76% a year.

⁷⁶ Earnings are assumed to increase by 2% a year above RPI inflation of 2.5%

First tier: Pension Credit

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

Guarantee Credit

Guarantee Credit replaced the Minimum Income Guarantee (MIG) in October 2003. Guarantee Credit (GC) is the name used for income support for people over the age of 60. 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 savings.⁷⁷

Its effect is redistributive – the benefit is paid for from taxes that are related to income and only paid to those on low income. From April 2011 GC ‘guarantees’ a minimum of £137.35 per week for single pensioners and a minimum of £209.70 per week for couples. The Government has announced that from April 2011 the GC will increase to £142.70 for singles and £217.90 for couples.⁷⁸

An individual or couple⁷⁹ is eligible for GC if they:

- are aged 60 or over (either person in the case of a couple). This age is progressively increasing in line with the increase in women’s SPA (see pages 26 to 28).⁸⁰
- on a low income, and
- working less than 16 hours a week (and any partner working less than 24 hours a week).

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 £10,000.⁸¹ The assessed savings include savings and investments, and property that is not the beneficiary’s main home.⁸² GC is currently

⁷⁷ 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.

⁷⁸ HMT (2011) Autumn Statement www.hm-treasury.gov.uk/as2011_index.htm

⁷⁹ Married, Civil Partners, or living together as husband and wife or as civil partners

⁸⁰ According to the announced changes in the Comprehensive Spending Review, women’s retirement age will increase faster than under the provisions of the Pensions Act 2007. This will affect entitlement to Pension Credit. These changes still need Parliament’s approval. See pages 26 to 29.

⁸¹ The amount of savings pensioners could have before their GC entitlement was reduced was £6,000 until November 2009 when it was raised to £10,000 See Budget 2009 speech, www.hm-treasury.gov.uk/bud_bud09_speech.htm

⁸² www.direct.gov.uk/en/Pensionsandretirementplanning/PensionCredit/DG_180168

reduced by £1.00 per week for each £500 (or part thereof) in excess of £10,000. This is more generous than under the MIG.⁸³

Savings Credit

Savings Credit (SC) attempts to encourage saving and ensure that anyone who has made some private saving for retirement will be better off than those who have not saved. However, those who do not have a full BSP will not receive credit for all of their savings. While GC is payable from age 60, SC 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 maximum SC that can be received in 2011/12 is £20.52 for single pensioners and £27.09 for couples. The Coalition Government has frozen the maximum amount of savings credit that individuals can qualify for, so these maximum rates will apply for the next four years (until 2014).⁸⁴ In 2011/12 the income above which people are no longer eligible to receive SC is £189 for single pensioners and £277.42 for couples.⁸⁵

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 2011/2012 the SC threshold for single pensioners is set at £103.15 per week, compared to the BSP of £102.15. In 2011/12, the SC threshold for couples is £164.55 per week.⁸⁶

The Government has announced that from April 2012 the SC threshold will be increased to £111.10 for single pensioners and to £177.20 for couples.⁸⁷

Example

Dolly is currently aged 65. She is entitled to a BSP of £92.15 per week - £10 below the maximum entitlement for a single person. She also receives an occupational pension of £30.00 per week giving her a total weekly income of £122.15. She is entitled to a guaranteed element of £15.20 from age 60 (to increase her income to the Guarantee Credit level of £137.35 per week). She also receives a savings credit of £11.40 per week i.e. 60% of the excess above £103.15, giving her a total weekly income of £148.75.

⁸³ Under the previous legislation the MIG was reduced by £1.00 per week for each £250 in excess of £6,000.

⁸⁴ See HMT (2010) *Comprehensive Spending Review*, p. 69. Available at www.hm-treasury.gov.uk/spend_index.htm

⁸⁵ 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.

⁸⁶ See DWP (2010) *Social Security Benefit Up-rating*.

⁸⁷ HMT (2011) *Autumn Statement 2011*. www.hm-treasury.gov.uk/as2011_index.htm

Example

Table 4 below shows the impact of various levels of accrued savings for a single person receiving only the 2011/12 BSP of £102.15. In this table savings above £10,000 are considered when calculating assumed savings income.

Table 4: Interaction of accrued savings with Pension Credit

Savings	Assumed Savings Income	GC Benefit	Total Weekly BSP + GC
£0	£0.00	£35.20	£137.35
£10,000	£0.00	£35.20	£137.35
£12,000	£4.00	£31.20	£133.35
£14,000	£8.00	£27.20	£129.35
£16,000	£12.00	£23.20	£125.35
£18,000	£16.00	£19.20	£121.35
£20,000	£20.00	£15.20	£117.35
£22,000	£24.00	£11.20	£113.35
£24,000	£28.00	£7.20	£109.35

Table 5 shows the interaction of Guarantee Credit with Savings Credit for various levels of assessed income for single pensioners and pensioner couples. The incomes given represent the total income considered for pension credit purposes. It may include, for example, basic state pension, additional state pension, private pension income, savings converted into notional income calculated for the pension credit calculation. Savings Credit can increase up to £20.52 per week (for a single pensioner), when income is £132.60 per week, and then begins to tail off for higher levels of income. Table 5 shows in bold the weekly income value at which GC and SC become zero because of hitting the assessed income limit.

Table 5: Interaction of income with GC and SC in the 2011/12 Tax Year

Single Pensioner				Pensioner Couple			
Weekly income	Guarantee Credit	Savings Credit	Total income	Weekly income	Guarantee Credit	Savings Credit	Total income
£70.00	£67.35	£0.00	£137.35	£140.00	£69.70	£0.00	£209.70
£80.00	£57.35	£0.00	£137.35	£150.00	£59.70	£0.00	£209.70
£90.00	£47.35	£0.00	£137.35	£160.00	£49.70	£0.00	£209.70
£100.00	£37.35	£0.00	£137.35	£170.00	£39.70	£3.27	£212.97
£110.00	£27.35	£4.11	£141.46	£180.00	£29.70	£9.27	£218.97
£120.00	£17.35	£10.11	£147.46	£190.00	£19.70	£15.27	£224.97
£130.00	£7.35	£16.11	£153.46	£200.00	£9.70	£21.27	£230.97
£132.60	£4.75	£17.67	£155.02	£202.40	£7.30	£22.71	£232.41
£140.00	£0.00	£19.46	£159.46	£210.00	£0.00	£26.97	£236.97
£150.00	£0.00	£15.46	£165.46	£220.00	£0.00	£22.97	£242.97
£160.00	£0.00	£11.46	£171.46	£230.00	£0.00	£18.97	£248.97
£170.00	£0.00	£7.46	£177.46	£240.00	£0.00	£14.97	£254.97
£180.00	£0.00	£3.46	£183.46	£250.00	£0.00	£10.97	£260.97
£188.64	£0.00	£0.00	£188.64	£260.00	£0.00	£6.97	£266.97
£190.00	£0.00	£0.00	£190.00	£270.00	£0.00	£2.97	£272.97
£200.00	£0.00	£0.00	£200.00	£277.42	£0.00	£0.00	£277.42

First Tier: Housing Benefit

Housing Benefit (HB) is a means-tested benefit that is designed to help individuals in rented accommodation to 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 available 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 excessive.⁸⁸

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 £157.90 per week for singles and £236.90 for couples from April 2011. This is intentionally set to broadly equal the Guarantee Credit level (currently £137.35 per week from April 2011) plus the maximum amount of Savings Credit (£20.52 per week until 2014). 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. In Budget 2010 it was

⁸⁸ 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.

announced that the highest rents across the country, including the most expensive 8 per cent of properties in London, will be excluded from the calculation of the Local Housing Allowance in each area from October 2011. Individuals can decide to live in more expensive accommodation than the allowance would cover, in which case they would have to find an amount to cover the difference, or live in cheaper accommodation, in which case they could keep 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.

Changes to Housing Benefit

The Coalition Government announced changes to the housing benefit from April 2011.⁸⁹ The Local Housing Allowance (LHA) will now be restricted to a maximum of four bedrooms for new and existing claimants. Alongside this, weekly LHA rates will be capped at £250 for a one bedroom property, £290 for two, £340 for three and £400 for a four bedroom property. The maximum rate of Housing Benefit will be limited to the rate for a four bedroom property.

From October 2011, LHA rates will be based on the thirtieth percentile of rents of the local area rather than the median. From April 2013 LHA will be uprated by CPI.

Other changes related to Housing Benefit will be introduced in phased stages until 2014. These are related to the deductions made if there is another adult living in the claimant's home, the rate for room share and the reduction in Housing Benefit for people who have been receiving Jobseekers' Allowance for more than one year.⁹⁰

Example

Susan is a 65 year old single woman who does not own her own home. She rents an apartment which costs her £85 per week. Her income from state and private pensions is £135 per week, which would entitle her to £21.46 per week from Pension Credit (made up of £2.35 from the Guarantee Credit and £19.11 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 the first £10,000 of savings is disregarded, leaving Susan £4,000 to be considered. This is converted into a

⁸⁹ These changes were announced in the June 2010 Emergency Budget, and provisions have been included in the draft Welfare Bill 2011, which is under consideration by Parliament.

⁹⁰ For more information see: www.direct.gov.uk/en/N11/Newsroom/DG_192415. See also www.dwp.gov.uk/local-authority-staff/housing-benefit/claims-processing/local-housing-allowance/impact-of-changes.shtml

“tariff income” for calculation purposes at £1 for every £500 of savings, giving Susan £8 of tariff income. This makes her income for Pension Credit calculations £138 (=£130 + £8). She would not receive income from the Guarantee Credit but her income from Savings Credit would be £18.26 per week.

Her deemed income in the calculation for her Housing Benefit entitlement could be £161.26 per week.

£161.26 = £18.26 (income from Savings Credit) + £135.00 (income from state and private pensions) + £8.00 (deemed income from savings. This is the same as the deemed income for pension credit because the calculation of tariff income from savings for housing benefit has the same savings disregard of £10,000⁹¹)

*This is £3.36 above the personal allowance for Housing Benefit (£157.90 per week in 2011/12), which would reduce her income from Housing Benefit by £2.18 per week (£3.36 * 0.65). So Susan would receive Housing Benefit worth £82.82 per week towards the cost of her rent.*

If her savings were £22,000, Susan would not be eligible to receive any Housing Benefit (since her savings would be above the £16,000 limit).

⁹¹ See DWP (2010) *Social Security Benefit Up-rating*, p.1.

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 payable 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 £157.90 per week from April 2011.⁹² 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. A 25% rebate is paid if the second adult is in receipt of Income Support, Income-based Jobseeker's Allowance or Pension Credit; this amount is reduced if the second adult has higher levels of income. For example, if their gross weekly income is less than £175.00, the rebate is 15% and if it is between £175.00 and £227.99 the rebate is 7.5%.

Whenever someone claims main Council Tax Benefit, SAR is also calculated. The claimant is then awarded whichever benefit (main CTB or

⁹² £236.80 per week for couples in 2011/12

SAR) is most advantageous to them. In practice, there are very few awards of SAR.⁹³

Example

Tim and Kate are a married couple and are both above age 65. Their Council Tax liability is £12.25 per week. Their combined income from state pensions is £215 per week, which would entitle them to £24.97 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 £239.97 per week (£215 + £24.97) is above the personal allowance for couples of £236.80 per week in 2011/12.

*Their deemed income is therefore £3.17 above the personal allowance, which would reduce their income from Council Tax Benefit by £0.63 per week ($£3.17 * 0.2$). So Tim and Kate would receive a Council Tax rebate worth £11.62 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) (2011) *Social Security Benefit Rates*
www.dwp.gov.uk/docs/benefitrates2011.pdf

⁹³ There were 5.0 million claimants of Council Tax Benefit at this date, compared to 35 thousand claimants of SAR. See DWP (2010) *Income-Related Benefits Take-up*.
www.research.dwp.gov.uk/asd/index.php?page=irb_2

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 £49.30 from April 2011 – payable if the individual needs personal care during either the day or the night. Attendance Allowance can only be claimed after age 65.
- Attendance Allowance - higher rate of £73.60 from April 2011 – 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 £19.55 and £73.60 per week from April 2011 for personal care, and a mobility component of between £19.55 and £51.40 per week from April 2011. This can only be claimed before 65, although payment can continue after 65.
- Carer's Allowance of £55.55 per week from April 2011 is payable to those spending at least 35 hours a week looking after someone receiving certain disability benefits including Attendance Allowance and Disability Living Allowance.⁹⁴

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 £100 per week or to those who receive benefits of £55.55 or more. The amount received can also be reduced if individuals receive other state benefits.⁹⁵ Carer's Allowance 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 before Christmas.⁹⁶
- Winter Fuel Payment - £200 per household where at least one person is age 60 or over, and £300 per household where at least

⁹⁴ Carer's Allowance is a maximum of £53.90 per week from April 2010, 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.

⁹⁵ See www.direct.gov.uk/en/CaringForSomeone/MoneyMatters/CarersAllowance/DG_10012522

⁹⁶ www.direct.gov.uk/en/MoneyTaxAndBenefits/BenefitsTaxCreditsAndOtherSupport/On_a_low_income/DG_10018704

one person is aged 80 or over - paid annually in December.⁹⁷ The qualifying age for this benefit increases in line with women's SPA. Therefore, the qualifying age for this benefit will be affected by the Coalition Government's announcement in October 2010 that they will raise the SPA faster than under the provisions of the Pensions Act 2007. However, these changes still need Parliament's approval.

- Free NHS prescriptions and eye tests for those over 60.
- Free TV Licences for those over 75.
- Free central heating installed for people receiving Pensions Credit and a £300 discount for other pensioners.
- Free off-peak nationwide bus travel for those aged over 60.

Tax Allowances

- The personal allowance (amount of income receivable before income tax becomes payable) is £9,940 for people aged between 65 and 74 and £10,090 for people age 75 and over.⁹⁸ This compares to an allowance for the under 65s of £7,475 in 2011/12.⁹⁹
- The married couple's allowance is £7,295 for those aged 75 and above. Tax relief of 10% is given on income in this band. Where income exceeds £24,000, any married couple's allowance is reduced at the rate of £1 for every £2 of 'excess' income, to a minimum of £2,800.¹⁰⁰ Personal allowances reduce at the same rate, to a minimum of £7,475.

⁹⁷ See: www.direct.gov.uk/en/Pensionsandretirementplanning/Benefits/BenefitsInRetirement/DG_10018657

⁹⁸ For people with incomes over £24,000 their personal allowance is reduced by £1 for every £2 over the £24,000 limit until it reaches the personal allowance for those under 65.

⁹⁹ From the 2010-11 tax year the Personal Allowance reduces where the income is above £100,000 - by £1 for every £2 of income above the £100,000 limit. This reduction applies irrespective of age. See changes in the tax allowance at www.hmrc.gov.uk/rates/it.htm

¹⁰⁰ 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: Overview

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 in a way that is 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)

Some of today's pensioners still receive small amounts of benefit from accrued rights to the **Graduated Retirement Benefit (GRB)**. For example, the maximum weekly benefit amount payable to a man retiring 2010/11 is £10.22.¹⁰¹ Further information on GRB is available in the Historical Annex that accompanies this document.¹⁰²

The **State Earnings-Related Pension Scheme (SERPS)** is much more significant for current pensioners.

The original aim of SERPS was to provide a pension of 25% of band earnings.¹⁰³ Subsequent changes to SERPS have reduced the value of SERPS benefits. A detailed discussion of the changes SERPS has undergone is available in the Historical Annex.¹⁰⁴

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.

¹⁰¹ Excluding any increments for delayed commencement

¹⁰² Available at www.pensionspolicyinstitute.org.uk

¹⁰³ Earnings between the Lower Earnings Limit and Upper Accrual Point

¹⁰⁴ Available at www.pensionspolicyinstitute.org.uk

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. As a result of provisions in the Pensions Act 2007, the earnings bands have been reduced from three to two since April 2010. The purpose is to progressively transform S2P into a flat rate benefit.

For low earners, a flat-rate of S2P pension is guaranteed. Higher earners accrue an additional earnings-related benefit. Disabled people, and some individuals with caring responsibilities, are credited into the flat-rate part of S2P.

Current working age employees can only accrue S2P as the SERPs scheme is closed to future accrual, however SERPs remains an important component of the income paid out to today's pensioners and will continue to do so for many years.

The maximum total benefit that can be received per week by a single person from a combination of GRB/SERPS/S2P is £159.52 (2011/12).¹⁰⁵

In the Primer we focus mainly on S2P and its predecessor SERPS. We have also published an historical annex which provides further background on the changes made to SERPs by successive Governments and on Graduated Retirement Benefit – the predecessor benefit to SERPs.

Consultation on State Pension Reform

The Coalition Government has issued a Green Paper to consult on the introduction of significant reforms that would change the current structure of the first and second tier of the state pension.¹⁰⁶

The Government is proposing to implement one of two possible reforms:

- an acceleration of the reforms legislated for in the Pensions Act 2007, so that the state pension would evolve into a two-tier flat-rate structure by 2020 instead of 2030;
- a more radical reform towards a single-tier flat-rate pension set above the current level of the BSP plus the maximum Guarantee Credit element of Pension Credit (estimated at £140 per week).

The Green Paper discusses and seeks evidence on the possible effects of each reform alternative plus any other alternative that stakeholders may want to discuss.

Under the first option, the system would retain its two tier structure albeit with a simplified structure for S2P accrual, which may help people to better

¹⁰⁵ See www.direct.gov.uk/en/Pensionsandretirementplanning/StatePension/DG_183780

¹⁰⁶ See DWP (2011) *A State Pension for the 21st Century*. Available at: www.dwp.gov.uk/docs/state-pension-21st-century.pdf

understand their state pension entitlement.

Under the second option, the state second pension (S2P) would be eliminated and everyone with at least 30 years of national insurance contributions would qualify for the new single-tier pension of £140 per week, in 2010 earnings terms. A minimum of 7 qualifying years of contributions would be necessary for individuals to be entitled to any portion of the single-tier pension. People would need a minimum of 30 qualifying contribution years to receive the maximum single-tier pension of £140 per week.

The elimination of S2P, while making the system more simple, would also lead to the elimination of contracting-out and, thus, scheme sponsors would no longer receive national insurance contributions rebates. This could impact on the running costs of defined benefit (DB) schemes, which have been under pressure since the last decade, partly due to increasing longevity risks.

Second tier: State Second Pension (S2P)

State Second Pension (S2P) is an additional state pension scheme introduced by the Government in 2002 under the Child Support, Pensions and Social Security Act 2000, as the successor benefit to SERPS. 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 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, or
- are members of a contracted-out occupational pension scheme.

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

S2P pension at SPA is based on band earnings. Before 6 April 2010, there were three bands. Following provisions in the 2007 Pensions Act, the former second and third bands have been merged.¹⁰⁷ The band earnings and accrual rates are the following:

- Those earning between the Lower Earnings Limit (LEL) of £5,304 per year (2011/12) and the Low Earnings Threshold (LET) of £14,400 per year (2011/12) are treated as if they earned £14,400. Benefit accrues at a rate of 40% of earnings within this band, which is twice the rate under SERPS.
- Those earning between £14,400 per year and the Upper Accrual Point (UAP) of £40,040 per year (2011/12) also accrue benefit but a rate of 10% of earnings within this band.
- Some carers¹⁰⁸ (caring for children under 12-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.

Changes in the Pensions Act 2007 increased the number of people accruing State Second Pension. Starting in April 2010, the changes have allowed people to be deemed to be earning at the LET by combining earnings below the LET with a more generous system of weekly credits.

¹⁰⁷ See www.scottishlife.co.uk/scotlife/localuserpage.asp?ae_bae=T&page=731. See also www.towerswatson.com/united-kingdom/research/1387. For the current earnings limits see also HMRC tables at www.hmrc.gov.uk/helpsheets/e12.pdf

¹⁰⁸ Before April 2010 not all carers could accrue benefits, as they had to have cared for the entire financial year. Shorter spells of caring or those that straddle two financial years did not qualify.

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 will no longer apply to disabled people from April 2010.

Transition towards a flat-rate S2P

Following provisions in the Pensions Act 2007, at some future date, the first band (40% accrual band) will be replaced by a weekly flat-rate accrual of £1.50 per week (£78 per year). The second band (10% accrual) will be withdrawn around 2030, leaving a wholly flat-rate benefit. Until that time, S2P benefits will continue to be related to earnings.

Sources

Department for Work and Pensions (DWP) (2008) *A Guide to State Pensions -NP46 Section - Additional State Pension*

Second tier: S2P accrual

Following provisions in the Pensions Act 2007, from April 2010, S2P band-earnings have been reduced to only two by merging the former 10% and 20% accrual rate bands into a single 10% band. The goal of these changes is to progressively move the S2P towards a flat-rate benefit. The two band-earnings are the following:

- The first band is between the Lower Earnings Limit (LEL) and the Low Earnings Threshold (LET) (£5,304 and £14,400 from April 2011).
- The second band is between the LET and the Upper Accrual Point (UAP) (£14,400 and £40,040).

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 within the first band
- 10%/49 - for earnings within the second band

Where earnings are below the LET, then the individuals are treated as if they earned at that threshold. Qualifying carers or disabled people are also treated as if they earned at that threshold. In the example below, anyone with earnings below or at the LET (£14,400) accrues £74 of S2P per annum as if they had earnings at the LET level.

Table 6 below shows the accrual under S2P for 2010/11.

Table 6: S2P accrual - 2011/12¹⁰⁹

Earnings from employment	Band earnings	S2P accrual (p.a.)
Carer - £0	-	£74
£3,000	-	£0
At LEL - £5,304	-	£74
£5,504	£200	£74
£10,000	£4,696	£74
At LET - £14,400	£9,096	£74
£19,000	£13,696	£84
£25,000	£19,696	£96
£32,600	£27,296	£111
£35,000	£29,696	£116
At UAP - £40,040	£34,736	£127
£50,000	£34,736	£127

Sources

Department for Work and Pensions (DWP) (2008) *A Guide to State Pensions -NP46 Section - Additional State Pension*

¹⁰⁹ Assumes potentially 49 years of service

Second tier: State Earnings Related Pension Scheme (SERPS)

SERPS, the precursor to State Second Pension, was introduced in 1978. 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.

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)¹¹⁰ - 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 using the Retail Prices Index (RPI). However, unlike the previous policies for BSP, SERPS is not subject to a guaranteed minimum increase of 2.5% in times of low inflation.

The Coalition Government announced that from April 2011 SERPS payments will be uprated by the yearly rise in the Consumer Prices Index (CPI) instead of the Retail Price Index (RPI).¹¹¹

All employees were members of SERPS, and will have earned SERPS entitlement 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.

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 was most disadvantageous to those

¹¹⁰ 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.

¹¹¹ Announced in the June 2010 Emergency Budget. See:

www.parliament.uk/briefingpapers/commons/lib/research/briefings/snbt-05649.pdf

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 instead.¹¹²

The Pensions Act 1995 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 UEL¹¹³ since 1978/9 and reaching SPA in 2011/12 is £159.52 per week.¹¹⁴ A more detailed discussion about SERPS is available in the Historical Annex.¹¹⁵

Sources

Department for Work and Pensions (DWP) (2008) *A Guide to State Pensions -NP46 Section – Additional State Pension*

Reardon A. (2002) *Zurich Pensions Handbook*

¹¹² See RN Second tier: Contracting-out

¹¹³ 53 times the weekly UEL per year

¹¹⁴ See www.direct.gov.uk/en/Pensionsandretirementplanning/StatePension/DG_183780. 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 £32,200 (2010/11).

¹¹⁵ Available at www.pensionspolicyinstitute.org.uk

Second tier: Contracting-out

Since the introduction of SERPS in 1978 and S2P in 2002 it has been possible for employers to set-up an occupational pension scheme that is contracted-out of SERPS/S2P.¹¹⁶ 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/S2P the individual would earn benefits within the occupational pension 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 must have estimated that at least 90% of the scheme membership will be better off than they would have been, had they remained in SERPS/S2P.

Since 1988, individuals who are members of a stakeholder or personal pension are able to contract-out of SERPS/S2P, receiving a rebate into their stakeholder or personal pension plan. 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-sum.¹¹⁷

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 (55, though the age was 50 until April 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/S2P pension given up.

In 1997/8 age-related rebates were introduced for people contracting-out into Defined Contribution occupational pensions and personal pensions. The rebates are set every five years by the Government Actuary Department (GAD) and they represent the actuarial equivalent of the SERPS/S2P benefits given up. In calculating the rebates GAD makes long term assumptions on investment returns, increases in National Average Earnings, interest rates available in the financial market and mortality improvements. The rebates are lower for younger individuals, reflecting the longer time period they are assumed to be invested for. Rebates are

¹¹⁶ See RN Second tier: Contracting-out of S2P

¹¹⁷ See RN Third Tier: Options for pension withdrawal

capped to a maximum of band earnings. In 2011, they were capped at 7.4%.¹¹⁸

Abolition of contracting out

From April 2012, it will be no longer possible to contract-out from S2P for members of occupational defined contribution (DC) schemes, stakeholder and personal pensions.¹¹⁹ Once this takes effect, people will start to build up rights to the State Second Pension. The changes imply that from April 2012 the HMRC will stop paying National Insurance Contribution rebates into occupational DC, personal or stakeholder pensions. It will still be possible for defined benefit (DB) schemes to be contracted-out.

Sources

Department for Work and Pensions (DWP) (2005) *Annual increases in rates of Pensions*

www.dwp.gov.uk/lifeevent/penret/penreform/7a_indexation.asp

Government Actuary's Department (GAD) (1996) *Occupational and Personal Pension Scheme – Review of Certain Contracting-Out terms*

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Government Actuary's Department (GAD) (2001) *Occupational and Personal Pension Scheme – Review of Certain Contracting-Out terms*

www.archive.official-documents.co.uk/document/cm50/5076/5076.pdf

Government Actuary's Department (GAD) (2006) *Occupational and Personal Pension Scheme – Review of Certain Contracting-Out terms*

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

¹¹⁸ It is a statutory requirement that rebate rates be reviewed every 5 years. In March 2011, GAD published a review of the rebates for the 2012-2017 period. Due to the abolition of contracting out for defined contribution schemes from 2012, the GAD review stated that the rebate for defined contribution pensions should remain at 7.4% of band earnings, as in the previous period. The report set the same cap for contracting out of defined benefit schemes. See GAD review page 94 at:

www.gad.gov.uk/Documents/Pensions%20Policy%20&%20Regulation/Contracting%20Out/Report_to_parliament_on_the_2011_review_of_contracting-out_terms.pdf

¹¹⁹ Provisions for this were legislated for in the Pensions Act 2007, following the recommendations of the Pensions Commission 2005. See also:

www.direct.gov.uk/en/MoneyTaxAndBenefits/Taxes/BeginnersGuideToTax/NationalInsurance/PayingreducedrateNationalInsurance/DG_190081

Second tier: Contracting-out - additional elements associated with S2P

The replacement of SERPS with S2P created some additional complications for contracting-out.

Contracting-out into an occupational DB 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 than they would have been if they had remained in SERPS/S2P. The enhancements to S2P would have forced schemes to revise their benefit structures.

At the time of the replacement of SERPS by S2P in 2002, it was decided that contracting-out would continue for both Defined Benefit and Defined Contribution occupational pension schemes on terms similar to those which applied 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 £32,600 (2010/11) 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 £14,400 will in addition accrue S2P benefits within S2P, as the flat-rate part of S2P assumes earnings of £14,400. The S2P benefit will be based on the difference between their actual earnings and £14,400.

As explained in the previous section, from April 2012 it will be no longer possible to contract-out of S2P using a DC occupational, stakeholder or personal pension.

Table 7: Residual pension accrued in S2P if contracted-out 2010/11

Earnings from employment	S2P accrual (p.a.)	Residual benefit accrued in S2P if contracted-out into:	
		Occupational pension scheme	Personal pension
Carer - £0	-	-	-
£3,000	£0	£0	£0
At LEL - £5,304	£74	£74	£74
£5,504	£74	£73	£73
£10,000	£74	£55	£36
At LET - £14,400	£74	£37	£0
£19,000	£84	£28	£0
£25,000	£96	£15	£0
At UET - £32,600	£111	£0	£0
£35,000	£116	£0	£0
At UAP - £40,040	£127	£0	£0

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. In order to illustrate the complexity of the decision, some of these factors are listed here.

Clearly if an individual is at an age where the age-related rebate is worth less than the benefits given up, he may get better value by not contracting-out.

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

If actual experience is worse than expected then the individual will have lost out by contracting-out because the pension from contracting-out will be lower than the SERPS/S2P pension given up. Whereas, if actual experience is better than expected, the individual will gain because 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 yearly income received from the annuity could be around 11% higher than if a joint life annuity had been purchased - although a spouse's pension would not be payable.¹²⁰

Rebates assume that certain charges are associated with managing and investing the pension fund and with purchasing an annuity. 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 55. However, people who built up entitlement in some contracted out occupational pension schemes before 6 April 1997 may not be able to access the contracted out portion of their pension until reaching SPA. 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,

¹²⁰ 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 CFEB's Comparative Tables (www.moneymadeclear.fsa.gov.uk/tables) as at 27 January 2011.

increasing SPA.¹²¹ 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 rates.¹²²

¹²¹ The Current Coalition Government has announced that it plans to increase the SPA for both men and women to 66 from 2018, six years earlier than under the plans of the former Labour Government.

¹²² 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 been 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.

Private pension provision can be made through:

- **Employer-sponsored pension schemes** (including Occupational Pension schemes)
- **Individual arrangements**, such personal pensions (including stakeholder pensions) and before 1988, retirement annuities.¹²³

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)** or **Defined Contribution (DC)**.

In **Defined Benefit (DB)** schemes, the benefit received upon retirement is determined by a formula which sets the levels of benefits to be offered, and is usually linked to final salary (or an average of salary over the length of an individual's period of employment). Contributions are paid into a common fund, which is invested to provide all retirement benefits.

Defined Contribution (DC) schemes operate on a money-purchase basis. Contributions are paid into individual accounts and the total benefit upon retirement depends on the value of the accumulated fund. An individual has to translate their pension fund in to an income through income drawdown or the purchase of an annuity.

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

¹²³ Access to new retirement annuities contracts ceased in 1988, however those with existing contracts may still contribute.

when the sponsoring employer has become insolvent.¹²⁴ 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).¹²⁵ 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.

Abolition of contracting-out

From April 2012, it will be no longer possible to contract-out from S2P for members of defined contribution (DC) schemes, stakeholder and personal pensions.¹²⁶ Once this takes effect, people who were previously contracted-out in DC schemes will start to build up rights to the State Second Pension. It will still be possible to contract-out from S2P for members of occupational DB schemes. Although the majority of active members of Defined Benefit schemes are contracted-out of the State Second Pension, only a small proportion of members in DC schemes are currently contracted-out of S2P.

Additional Voluntary Contributions

If individuals in an occupational scheme wish 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.

¹²⁴ 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).

¹²⁵ See RN Second tier: Contracting-out

¹²⁶ Provisions for this were legislated for in the Pensions Act 2007, following the recommendations of the Pensions Commission 2005. See also:

www.direct.gov.uk/en/MoneyTaxAndBenefits/Taxes/BeginnersGuideToTax/NationalInsurance/PayingreducedrateNationalInsurance/DG_190081

Personal Pensions

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 provision,¹²⁷ have been required to designate a stakeholder provider but employers are not currently required to make any contribution.

Employees can contract-out of S2P and receive rebates either into their group pension or into a standalone arrangement.¹²⁸

Automatic Enrolment into private pensions from 2012

The previous Labour Government acted on the recommendations of the Pensions Commission¹²⁹ and legislated in the Pensions Act 2008 for the introduction of automatic enrolment into private pensions for all employees between age 22 and State Pension Age to be phased in from October 2012. Employees will have the right to opt-out. The Pensions Act 2011 sets the earnings threshold above which every worker should be auto-enrolled at the same level as the income tax threshold (£7,475 in 2011/12).¹³⁰ Contributions become payable on band earnings over £5,715 and up to a limit of £38,185 in 2010/11.¹³¹

Upon auto-enrolment, minimum total contributions of 8% of earnings within designated bands will be paid to a qualifying pension scheme, with a minimum 3% from the employer. The employee and the Government could also contribute. The specific employee contribution rate will depend on the employer contribution. The Government contribution will be proportional to the employee contribution, as it is calculated as tax relief on employee contribution. If the employer decides to contribute the legal

¹²⁷ An occupational pension scheme or a GPP with a minimum 3% contribution, or some combination, open to all employees

¹²⁸ Employees could contract out of SERPS before it was replaced with S2P in 2002

¹²⁹ See Pensions Commission (2005) *A New Pension Settlement for the Twenty-First Century*

¹³⁰ See Pensions Act 2011, part 2 section 4.

¹³¹ See DWP (2011) *Automatic Enrolment and Workplace Pension Reform – The Facts*, p.9. Available at: www.dwp.gov.uk/docs/auto-enrol-and-wpr-the-facts.pdf

minimum of 3% of band earnings, then the employee will have to contribute 4% and the Government will contribute 1% through tax relief.¹³² However, it will be up to employers to decide whether they want to contribute the legal minimum or more.

National Employment Savings Trust (NEST)

The Pensions Act 2008 also provides for the introduction of a new pension saving scheme of low-cost, individualised pension savings accounts from October 2012 called NEST (National Employment Savings Trust). Employers who do not offer an occupational pension or a stakeholder or other qualifying pension scheme will be able to auto-enrol their employees into NEST, provided that the employee's earnings are above the current proposed auto-enrolment threshold of £7,475. Employees with earnings below this level will be permitted to opt in to the scheme. There will be a contributions limit of £4,300 a year into NEST.¹³³

NEST will have a low-charging structure. Members will pay an Annual Management Charge of 0.3% of the fund per year. However, until the start-up costs of the scheme are recovered, NEST members will also pay a 1.8% charge on contributions.¹³⁴

Staging and phasing of auto-enrolment

Automatic enrolment will start in October 2012 with large employers enrolling their eligible employees in a staged process. The Government has recently announced that medium and small employers will be given additional time to automatically enrol their eligible employees.¹³⁵

Large employers with 250 or more employees will not face any change in the date they are due to enrol their eligible employees and they will begin to do so from 1 October 2012 to 1 February 2014.

Medium sized employers with 50 to 249 employees will have automatic enrolment dates between 1 April 2014 and 1 April 2015. This means that the implementation dates of some of these employers will be up to nine months later than originally planned.

Small employers with less than 50 employees will have automatic enrolment dates from 1 June 2015 to 1 April 2017.

New employers setting up business from 1 April 2012 and up to and including

¹³² The tax relief may be higher for those people who pay higher-rate tax

¹³³ Equivalent to £3,600 in 2005/2006 earnings terms. See Johnson, P. Yeandle, D. Boulding, A. (2010) *Making automatic enrolment work: A review for the Department for Work and Pensions*, p.19 www.dwp.gov.uk/docs/cp-oct10-full-document.pdf

¹³⁴ Announced on 24 November 2010. *Press Release: NEST Corporation Sets NEST Charging Level.* www.nestpensions.org.uk/documents/NEST_Corporation_sets_NEST_charging_level.pdf

¹³⁵ DWP (2012) "New timetable clarifies automatic enrolment starting dates" dwp.gov.uk/newsroom/press-releases/2012/jan-2012/dwp010-12.shtml

30 September 2017 will have automatic enrolment dates between, and including, 1 May 2017 and 1 February 2018. So all employers will be automatically enrolling their eligible employees from 1 February 2018. Any new employer setting up business from 1 October 2017 onwards will be required to comply immediately if paying earnings which attract PAYE deductions in respect of any worker.

Minimum employer contributions will be phased-in starting at a minimum 1% of band earnings in October 2012. The Government announced that the increase in minimum employer contributions from 1% to 2% will now begin on 1 October 2017. Contributions will then increase to 3% from 1 October 2018.

Tax Simplification

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 rules.¹³⁶ Compared to the pre-April 2006 system, there is no limit on the amount of pension saving that an individual can build up in a registered pension scheme.¹³⁷ 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 joining.¹³⁸

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 2010/11 this is £255,000), 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) 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 £1.8 million in 2011/12, 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.

¹³⁶ 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

¹³⁷ All pension schemes must be registered with the HM Revenue and Customs in order to qualify for tax relief and exemption from various taxes

¹³⁸ Although exemptions to the lifetime allowance are available to protect existing rights

From April 2010 the new top rate of tax to be paid on earnings above £150,000 is 50%.¹³⁹

Changes to Tax Relief: Annual Allowance

The Coalition Government announced changes to restrict pensions tax relief.¹⁴⁰ Following a consultation process in December 2010,¹⁴¹ the Government published draft legislation on tax relief that will be incorporated into the Finance Bill 2011.¹⁴² The changes related to the Annual Allowance became effective from 6 April 2011 and they mean that the AA has been reduced to £50,000. However people will be able to carry forward any unused allowance in the last three years.

Changes to Tax Relief: Lifetime Allowance

The Lifetime Allowance (LTA) will also be reduced as a consequence of the changes incorporated to the Finance Bill 2011. These changes will be effective from 6 April 2012 and as a consequence the LTA will be reduced from £1.8 million to £1.5 million.¹⁴³

Options for pension withdrawal

In April 2010 the minimum age at which private pensions could be taken was increased from age 50 to 55. 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 a one-off 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 (£18,000 in 2010/11), 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'.** Also known as an Unsecured Pension Arrangement (USP). 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.
- **Annuity.** An insurance product that pays an income from the date of purchase until the date of death.¹⁴⁴ Annuity payments are usually taxed as income.

¹³⁹ See rates at HMRC website: www.hmrc.gov.uk/rates/it.htm

¹⁴⁰ Announced in the 2010 Emergency Budget.

¹⁴¹ See HMT (2010) *Restriction of pensions tax relief: a discussion document*

¹⁴² See HMT (2010) *Restricting Pensions Tax Relief*. Available at www.hm-treasury.gov.uk/d/restricting_pensions_tax_relief.pdf

¹⁴³ For more details see box in page 84. See also the clauses on tax relief in the draft Finance Bill 2011 at: www.hm-treasury.gov.uk/d/restricting_pensions_tax_relief.pdf

¹⁴⁴ An annuity insures against an individual's money running out because he or she lives longer than expected

Prior to April 2006, individuals, on reaching age 75 were effectively required to purchase an annuity with their pension pot. Between 2006 and 2010, if a person had private pension savings above the trivial commutation limit and had not opted for an annuity by the time they reached age 75 they were required to begin withdrawing their pension benefits, either by purchasing an annuity or by the additional option of an alternatively secured pension (ASP), primarily for those who had a principled religious objection to buying an annuity.

Elimination of the requirement to purchase an annuity by age 75

In June 2010 the Coalition Government announced plans to remove the effective requirement to buy an annuity by age 75.¹⁴⁵ At that time, the age at which people were required to purchase an annuity was temporarily raised to 77 in order to allow people near age 75 to delay purchasing an annuity until the new legislation was put in place. A consultation paper was issued in July 2010 asking for recommendations from stakeholders for future legislation.¹⁴⁶

In December 2010, the Government published its response to the consultation and the draft clauses with the changes on this subject to be incorporated to the Finance Bill 2011. The changes became effective from 6 April 2011.¹⁴⁷ The main aspects of the changes are the following:

- An individual can purchase an annuity with all or part of their pension savings from age 55 without restriction. The age 75 restrictions on value protection, trivial commutation and pension commencement lump sums is removed.
- USPs and ASPs are replaced by a single product - Capped Drawdown - available from age 55 without restriction; however, withdrawals will be capped at 100% of an equivalent annuity.
- Individuals demonstrating that they can satisfy a Minimum Income Requirement (MIR) by demonstrating that they have a secure, lifetime income of at least £20,000 per year, will be able to drawdown unlimited amounts from their pension pots, subject to income tax at their marginal rate. The purpose of the MIR is to ensure that an individual entering Flexible Drawdown has sufficient income to avoid subsequently falling back on the state.

Currently, individuals cannot access their private pension saving until they reach the minimum pension age (age 55 from April 2010). There has been some debate about whether this lack of access to private pension saving discourages individuals from saving in a pension.

¹⁴⁵ Announced in the 2010 Emergency Budget.

¹⁴⁶ See HMT (2010) *Removing the requirement to annuitise by age 75*

¹⁴⁷ See HMT (2010) *Removing the requirement to annuitise by age 75 December 2010 A summary of the consultation responses and the Government's response*. Available at www.hm-treasury.gov.uk/d/consult_age_75_annuity_responses.pdf

Call for Evidence on early access to pension savings 2010

The Coalition Government issued a Call for Evidence in December 2010 on whether it might be beneficial to allow access to pension savings earlier than the current threshold of 55 years of age under certain provisions and for specific purposes.¹⁴⁸ In the document, the Government stated that early access could provide more flexibility to individuals facing financial hardship; however, the Government also acknowledged that early access could pose potential risks to retirement income, which should be carefully considered.

The Call for Evidence identified four early access models on which it sought views from interested parties on their merits, the risks involved and the costs to individuals, pension providers and schemes.

In April 2011 the Government published its response concluding that early access to pension saving should not be considered at the present given the limited evidence that early access would have a positive impact on pension saving and the undergoing reforms to private pension provision, most notably auto-enrolment from October 2012. The Government stated that after auto-enrolment is implemented, it intends to carry out research to assess why people decide to opt out. If the evidence suggests that access to pensions savings is a critical factor, the Government may consider to revisit the issue of early access.¹⁴⁹

¹⁴⁸ HMT (2010) *Early Access to Pensions Savings*. Available at www.hm-treasury.gov.uk/d/call_for_evidence_on_early_access_to_pension_savings.PDF

¹⁴⁹ *Early access to pension savings. A summary of responses to the call for Evidence*. Available at: www.hm-treasury.gov.uk/d/consult_early_access_pension_savings_summary_responses.pdf

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 pension scheme is based on an individual's earnings at, or close to, leaving the scheme and their length of service. Career average schemes 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 65.¹⁵⁰ A member can usually take benefits early but is likely to incur a reduction in the accrued benefits to compensate for the longer time that benefits are payable

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, and 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 an annuity is purchased (which depend on age, sex, health, profile of

¹⁵⁰ See ONS (2009) *Occupational Pension Schemes Survey* Table 2.19
www.statistics.gov.uk/downloads/theme_population/occ-pension-2009/opss2009final.pdf

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, then the resultant pension will be lower, whereas conversely if they are better, then 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 scheme 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

Some 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 an employer 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 currently required to make any contributions, although this will change once the requirement to auto-enrol all eligible employees comes into place in 2012.

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.¹⁵¹

¹⁵¹ See RN Third tier: Individual pension arrangements

Auto-enrolment test

With the introduction of auto-enrolment and NEST 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 NEST.¹⁵² In order to qualify as an auto enrolment scheme, a pension scheme must:

- Allow contributions to be made by the employer,
- Be “registered”, this means the type of scheme that receives tax advantages under the Finance Act 2004,
- Defined Contribution schemes must have employer contributions of at least 3%, and total contributions of at least 8%, of qualifying earnings,
- Defined Benefit schemes must be contracted out, or satisfy the Test Scheme standard for all active members,¹⁵³
- Hybrid schemes must satisfy either the money purchase requirement or the Defined Benefit requirement as appropriate according to rules set out by the Secretary of State.

¹⁵² This was implemented as a consequence of the provisions legislated in the Pensions Act 2008 related to the introduction of automatic enrolment into private pensions and the rolling out of NEST from October 2012.

¹⁵³ Test Scheme is a scheme that provides a pension from age 65 of $1/120 \times$ average qualifying service over the last 3 tax years before retirement for each year of qualifying service.

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 Occupational Pension schemes that are underfunded when they begin to wind up and/or where the employer is insolvent or no longer exists.¹⁵⁴ 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 FAS.¹⁵⁵

In addition, the Pension Protection Fund (PPF) became operational in April 2005.¹⁵⁶ 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 underfunded.

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%,¹⁵⁷ although from April 2011, payments will be increased in line with the rise in the Consumer Prices Index (CPI). Compensation payments are subject to an overall cap, which from April 2011 begins at £33,219.36 at age 65 for current pensioners (£29,897 for those not yet receiving a pension), and is adjusted depending on the age that the pension comes into payment.¹⁵⁸ These factors may mean that pensions

¹⁵⁴ See DWP Pension Reform - Financial Assistance Scheme
www.dwp.gov.uk/lifeevent/penret/penreform/fas/

¹⁵⁵ 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

¹⁵⁶ See www.pensionprotectionfund.org.uk for further information on the PPF

¹⁵⁷ Relates to service made on or after 6 April 1997 only

¹⁵⁸ See PPF(2011) *Compensation Cap Factors*. Available at:

www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/Compensation_cap_factors_Apr_2011.pdf

received from the PPF are smaller than some members had expected to receive from their original scheme.

Compensation payments are 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 administration levy is set in statute and covers the PPF's initial start-up and running costs. The pension protection levy is 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.

From September to November 2010 the PPF consulted stakeholders on changes to its levy framework. In December 2010 the PPF published its response to the consultation¹⁵⁹ and in January 2011 it was announced that a new levy framework will be introduced from 2012/2013, although the details of it will be announced later in the spring 2011.¹⁶⁰

¹⁵⁹ See the response to the consultation at

www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/1112_levy_policy_statement.pdf

¹⁶⁰ www.pensionprotectionfund.org.uk/news/pages/details.aspx?itemID=209

Third tier: Pension fund regulatory framework

The Pensions Act 2004 introduced a number of changes to the regulation of Occupational Pension schemes.¹⁶¹

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 Fund.¹⁶²

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 Regulator.¹⁶³

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 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:

- Trustees to publish a Statement of Funding Principles, setting out funding strategies and strategies to tackle funding deficits.

¹⁶¹ Outlined in DWP (2003) *Simplicity, security and choice: Working and saving for retirement action on occupational pensions*

¹⁶² See www.thepensionsregulator.gov.uk

¹⁶³ See Trustees and the Pensions Regulator www.thepensionsregulator.gov.uk/trustees/index.aspx

- 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 actuarially 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 employer.¹⁶⁴

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

¹⁶⁴ 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.

Prior to 2001, 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 further,¹⁶⁵ 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 joined 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, when applicable, an employer will be invested and the accumulated fund will be used to provide a tax-free lump sum plus a pension.¹⁶⁶

Contributions to personal pension schemes are subject to the lifetime and annual allowances.¹⁶⁷

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, £18,000 in 2011/12). Where the fund being taken as cash has not vested, 25% of the lump sum is tax free;¹⁶⁸ with the balance being taxed as

¹⁶⁵ 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.

¹⁶⁶ 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%

¹⁶⁷ See RN on Tax treatment of private pension provision

¹⁶⁸ 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: 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 earned.¹⁶⁹ 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 pensions.¹⁷⁰ 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 received.¹⁷¹

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.

¹⁶⁹ For contributions of more than £3,600 a year

¹⁷⁰ 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

¹⁷¹ 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 and/or the increase in value of benefits under Defined Benefit arrangements for an individual are more than the annual allowance (AA), which was £255,000 in 2010/11 but that has been reduced to £50,000 in 2011/12, the individual will be taxed at the rate of 40% on the excess.¹⁷²

Upon accessing benefits in retirement, an individual's total pension savings will be tested against a lifetime allowance (LTA), whose purpose is to regulate the amount of tax relief individuals get over their working life. In 2011/12, the LTA is £1.8 million. Any excess over this limit will be taxed at 25% if the benefits are taken as a pension or 55% if they are taken as a lump sum.

Fund Accumulation - mainly 'Exempt'

The pension 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 Advance Corporation Tax (ACT) on UK dividends.¹⁷³

From April 2006, an individual can build up their pension funds tax-free until the total exceeds the lifetime allowance, which is set at £1.8 million for 2011/12 (though it will be reduced to £1.5 million from 2012/13).

Proceeds - mainly 'Taxable'

At 'retirement' up to 25% of the retirement fund can be taken as a tax-free lump sum. The remainder of the fund can be used to provide a lifetime income through purchase of an annuity, unsecured pension or alternatively secured pension (ASP) or, from April 2011, it can be invested in Capped Drawdown or withdrawn flexibly if the fund holder meets the Minimum Income requirement. 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.

¹⁷² See: www.pensionsadvisoryservice.org.uk/personal--stakeholder-pensions/stakeholder-pension-schemes/contribution-levels--tax-relief

¹⁷³ For more information on this see PPI (2005) Briefing Note Number 18 Is £5 billion being taken from pension funds each year?

Changes to Tax Relief: Annual Allowance

Following a consultation process in December 2010,¹⁷⁴ the Coalition Government published draft legislation for the Finance Bill 2011 containing proposed changes to tax relief.¹⁷⁵ The changes regarding the Annual Allowance (AA) became effective from 6 April 2011. As a consequence the AA is now £50,000, however people will be able to carry forward any unused allowance in the last three years.

For the AA changes, the valuation factor used to calculate the value of Defined Benefit pension savings will increase from a factor of 10 to a factor of 16. Transitional rules have been put in place for individuals who contributed to a pension before 14 October 2010 but will have their contributions assessed for tax in the 2011/12 tax year.

In the impact assessment of the draft legislation, the Treasury estimates that the Government will achieve savings in the region of £4 billion and that the overall number of pension savers who would potentially be affected by the reduced AA would be around 100,000; 80% of whom are estimated to have incomes over £100,000.¹⁷⁶

The AA will not be raised until 2016, when the position will be reviewed. The number of individuals affected could therefore increase due to earnings growth. In addition, high earners in Defined Contribution schemes could limit their contributions to avoid a tax charge, but face the prospect of a lower income in retirement. Meanwhile, high earners in Defined Benefit schemes could face either paying a tax charge or negotiating reduced benefits under their scheme in order to avoid paying the extra tax charge.¹⁷⁷

Changes to Tax Relief: Lifetime Allowance

As part of the changes introduced by the Coalition Government into the Finance Bill 2011, the Lifetime Allowance (LTA) will be reduced from £1.8 million to £1.5 million from 2012/13.

Death prior to retirement

If an individual dies before converting their pension savings into an income, 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.

¹⁷⁴ See HMT (2010) *Restriction of pensions tax relief: a discussion document*

¹⁷⁵ See HMT (2010) *Restricting Pensions Tax Relief*. Available at www.hm-treasury.gov.uk/d/restricting_pensions_tax_relief.pdf

¹⁷⁶ See HMT (2010) *Restricting Pensions Tax Relief*, p.3

¹⁷⁷ For more detailed analysis of the impact of tax changes see PPI (2010) *The Impact of Tax Policy on Employer Sponsored Pension Provision*, chapter 3.

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 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 at which people can withdraw their pension benefits from age 50 to age 55 on April 6 2010. It also introduced 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 scheme,¹⁷⁸ including protected rights pensions,¹⁷⁹ 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’), also known as unsecured pension arrangement (USP). This allows an individual to draw an income from their pension fund whilst leaving the remaining fund

¹⁷⁸ For occupational schemes, the amount up to a maximum of 25% that can be taken as a lump sum depends on the scheme rules

¹⁷⁹ This is the part of a pension fund that was used to contract-out of the additional state pension (SERPS or S2P)

invested. The minimum and maximum amounts available for withdrawal are set by Government.

- Annuity. An insurance product that pays an income from the date of purchase until the date of death.¹⁸⁰ Annuity payments are usually taxed as income.

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, £18,000 in 2011/12). Where the fund being taken as cash has not vested, 25% of the lump sum is tax free,¹⁸¹ with the balance being taxed as 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.

To ease the administration of making certain trivial commutation payments, the previous Labour Government changed the rules in Budget 2008 regarding small 'stranded' pension pots in occupational pension schemes. From 1st June 2009 people have been allowed to take funds of £2,000 or less as a lump sum, even if an individual has multiple pension funds worth more than the trivial commutation limit (£18,000 in 2011/12.)¹⁸² The changes are designed to ease the administration of certain occupational pension schemes and will not apply to personal or stakeholder pensions, to prevent possible abuse.

Annuities

Most annuities purchased are level; meaning that once the annuity is purchased, the level of income an individual receives from it is then set for the remainder of the individual's life.

The cost of an 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-

¹⁸⁰ An annuity insures against an individual's money running out because he or she lives longer than expected

¹⁸¹ Protection exists for individuals who would have been entitled to a larger tax-free lump sum prior to the April 2006 changes

¹⁸² For more information see Budget 2008 Impact Assessment
www.hm-treasury.gov.uk/media/E/5/bud08_impact_147.pdf and
www.opsi.gov.uk/si/si2009/pdf/uksi_20091172_en.pdf

term annuity which provides an income for up to five years whilst the rest of the pension fund remains invested. People 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.

Prior to April 2006, individuals reaching age 75 were effectively required to purchase an annuity with their pension pot. Between 2006 and 2010, if a person with private DC pension savings had not opted for an annuity by the time they reached age 75, they were required to begin withdrawing their pension benefits, either by purchasing an annuity or by the additional option of an alternatively secured pension (ASP).

An ASP is a way of drawing an income from a pension fund without having to buy an annuity. ASPs were originally introduced for those who have a principled religious objection to the pooling of mortality risk in annuities.¹⁸³ Following concerns that ASPs were used by some people to accumulate capital, rather than to provide an income in retirement, the previous Labour Government introduced legislation requiring people to withdraw a minimum level of income from an ASP.

Currently, the minimum income withdrawal 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 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.

Changes to the requirement to purchase an annuity by age 75

The Coalition Government announced plans to remove the requirement to purchase an annuity by age 75 in June 2010.¹⁸⁴ Provisional legislation was put in place raising the age requirement to 77 years, until the new legislation is put in place.

Following consultation in December 2010,¹⁸⁵ the Government introduced new legislation into the Finance Bill 2011. The changes took effect from 6 April 2011.¹⁸⁶ The main aspects of the changes are the following:

¹⁸³ See the proposed clauses related to changes in Annuitisation in HMT(2010) *Removing the requirement to annuitise by age 75*, p.7

¹⁸⁴ Announced by the Chancellor in the June 2010 Emergency Budget.

¹⁸⁵ See HMT (2010) *Removing the requirement to annuitise by age 75 December 2010 A summary of the consultation responses and the Government's response*. Available at www.hm-treasury.gov.uk/d/consult_age_75_annuity_responses.pdf

- An individual can purchase an annuity with all or part of their pension savings from age 55 without restriction. The age 75 restrictions on value protection, trivial commutation and pension commencement lump sums have been removed.
- USPs and ASPs will be replaced by a single product - capped drawdown - available from age 55 without restriction, although withdrawals will be capped at 100% of an equivalent annuity.
- Individuals demonstrating that they can satisfy a Minimum Income Requirement (MIR), consisting of a secure, lifetime income of at least £20,000 per year, will be able to drawdown unlimited amounts from their pension pots, subject to income tax at their marginal rate. The purpose of the MIR is to ensure that an individual entering flexible drawdown has sufficient income to avoid subsequently falling back on the state.

Currently, individuals cannot access their private pension saving until they reach the minimum pension age (age 55 from April 2010). There has been some debate about whether this lack of access to private pension saving discourages individuals from saving in a pension.

Call for Evidence on early access to pension savings

The Coalition Government issued a Call for Evidence in December 2010 on whether it might be beneficial to allow access to pension savings earlier than the current threshold of 55 years of age under certain provisions and for specific purposes.¹⁸⁷ In the document, the Government stated that early access could provide more flexibility to individuals facing financial hardship; however, the Government also acknowledged that early access could pose potential risks to retirement income, which should be carefully considered.¹⁸⁸

In April 2011 the Government published its response to the consultation concluding that early access to pension saving should not be considered at the present given the limited evidence that early access would have a positive impact on pension saving and the undergoing reforms to private pension provision, most notably auto-enrolment from October 2012.

The Government stated that after auto-enrolment is implemented, it intends to carry out research to assess why people decide to opt out. If the evidence suggests that access to pensions savings is a critical factor, the Government may consider revisiting the issue of early access. The

¹⁸⁶ See HMT (2010) *Removing the requirement to annuitise by age 75 December 2010 A summary of the consultation responses and the Government's response*. Available at www.hm-treasury.gov.uk/d/consult_age_75_annuity_responses.pdf

¹⁸⁷ HMT (2010) *Early Access to Pensions Savings*. Available at www.hm-treasury.gov.uk/d/call_for_evidence_on_early_access_to_pension_savings.PDF

¹⁸⁸ For more details on the implications of implementing different early retirement options, see PPI (2008) *Would allowing early access to pension savings increase retirement incomes?* Available at: www.pensionspolicyinstitute.org.uk/uploadeddocuments/PPI_early_access_to_pension_saving_18_Nov_2008.pdf

Government also stated that it plans to explore over the coming months how the development of innovative saving models such as feeder funds could be facilitated within the current pensions tax framework.¹⁸⁹

¹⁸⁹ See HMT (2011) *Early access to pension savings. A summary of responses to the call for Evidence*, p.4-5.

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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