Contracting out of the State Second Pension

Standard Note: SN/BT 4822
Last updated: 23 March 2011
Author: Djuna Thurley
Section Business and Transport Section

The UK is unusual in having a state pension system which allows employers and employees to opt out of the Additional State Pension (State Earnings Related Pension Scheme from 1978 to 2002; State Second Pension from 2002) into alternative private pension provision which meets specified requirements. This process is known as contracting out.

Contracted-out employees and (where relevant) their employers pay a lower rate of National Insurance Contributions (NICs) via a "contracted-out rebate". This is in recognition of the fact that they lose their entitlement to the earnings-related element of the State Pension as a result of being contracted-out. When a person who has been contracted-out reaches State Pension age, the Pension Service may make a "contracted-out deduction" from the maximum amount of Additional State Pension (SERPS/S2P) they would otherwise have received.

The Pensions Commission in its Second Report (November 2005) concluded that that contracting out had added complexity to the UK pension system and was poorly understood. It recommended that the contracting out option should be abolished for Defined Contribution (DC) schemes but retained for Defined Benefit (DB) schemes for the foreseeable future. The *Pensions Act 2007* included measures to abolish the contracting out option for DC schemes. The intention is for this option to be abolished from April 2012.

The Office of Tax Simplification recommended on 3 March that contracting out for DB schemes should be abolished. In the March 2011 Budget, the Government said it would consult on proposals for reforming the State Pension, including on the option of introducing a single-tier state pension (which would entail the abolition of contracting-out).

The level of rebate that will apply to contracted-out Defined Benefit schemes from April 2012-2017 were announced on 3 February 2011.

This note provides an overview of the operation of contracting-out. Other Library standard notes of relevance are SNBT/2674, *State Second Pension: Contracted-out deductions* and SNBT/255, *State Second Pension*. The development of contracting out is covered in more detail in Library Research Paper 07/05, *'The Pensions Bill [Bill 12 of 2006-07]'*.

Contents

1 What is contracting out? 3

2 The development of contracting out 4

2.1 Contracting out and Defined Benefit (or salary-related) schemes 4

GMP conversion 4

Interaction with the State Pension 5

2.2 Contracting out and Defined Contribution (money purchase) schemes 6

Interaction with the State Pension 6

2.3 Contracting out and "mixed benefit" schemes 7

3 The future of contracting-out 7

DC schemes 7

DB schemes 10

Responses 12

4 Contracted-out rebates 12

4.1 Rates for 2007-2011 13

Comment 14

4.2 Rates for 2012-2017 15

Initial comment 18

Debate on the SI 19

5 The decision to contract out 21

5.1 Were people wrongly advised to contract out? 21

5.2 Should people be contracted out now? 24

6 Information and guidance 25

1 What is contracting out?

The state pension is made up of two parts: the basic State Pension (£97.65 a week in 2010-11) which depends on the number of qualifying years that a person has built up in their working life and the Additional Pension, which depends on the person's earnings. The Additional Pension was introduced in 1978, in the form of the State Earnings Related Pension Scheme (SERPS). In 2002, this was reformed and the State Second Pension was introduced. Since its introduction in 1978, it has been possible to contract out of the Additional Pension (SERPS/S2P) into either an occupational or personal pension scheme which fulfils certain criteria. In return, the employee and (where relevant) employer pay reduced National Insurance Contributions (NICs). Under the *Pensions Act 2007,* this option is to be abolished for Defined Contribution schemes (see section 3 below).

The Pension Service leaflet, *Contracted-out pensions,* provides the following explanation:

> **What is contracting-out?**
>
> 'Contracting-out' means leaving the State Second Pension scheme. If you are an employee, you can do this if you join a contracted-out:
>
> - occupational pension scheme, or
> - personal pension scheme or stakeholder pension scheme that is also known as an appropriate scheme (this means a scheme that members can use to contract out).
>
> If you are not able to join an occupational pension scheme, you will only be able to contract out by joining an appropriate contracted-out scheme.
>
> Apart from salary related pension schemes, the tax year 2011/12 will be the last year that you can contract out into these types of pension arrangement. See page 19 for more about the ending of contracting-out on a money purchase basis.
>
> You might choose to contract out into a personal pension scheme or stakeholder pension scheme if your employer does not run an occupational pension scheme, or if it does but you don't want to join.
>
> If you decide to contract out, your State Second Pension may be reduced or not paid; this is to reflect the time you were contracted-out. Instead of a State Second Pension, you would get a contracted-out pension for the contracted-out period. Contracting-out does not affect your right to the basic State Pension.
>
> **Can I contract out of the State Second Pension?**
>
> To contract out you must be:
>
> - earning at least the amount of the lower earnings limit (this is £97 a week/£5,044 a year for the 2010–11 tax year), and
> - paying or treated as paying standard-rate Class 1 National Insurance contributions on those earnings.
>
> This means you cannot contract out if you are:
>
> - self-employed

- a married woman who has chosen to pay reduced-rate National Insurance contributions, or
- not employed.[1]

2 The development of contracting out

There are different arrangements for contracting out depending on whether someone contracts out into an occupational salary related pension scheme (Defined Benefit scheme), an occupational money purchase (Defined Contribution) scheme or a personal pension scheme. The rules have changed several times over the years. A more detailed description of the development of the rules up to the *Pensions Act 2007* can be found in House of Commons Library Research Paper 07/05, *The Pensions Bill [Bill 12 of 2006-07]* (pages 73 to 89). A brief overview of the main changes is provided below.

Contracting out was introduced in April 1961 with the graduated pension scheme which yielded Graduated Retirement Benefits (GRB). Employers were able to contract out and pay lower National Insurance Contributions (NICs) if they provided Equivalent Pension Benefits (EPBs). The Office of Tax Simplification, which looked at contracted-out rebates in 2010/11, noted that it was "unclear what the original policy rationale was."[2]

The scheme was wound up in 1975 and most contracted-out employers bought prospective pensioners back into the state scheme, thereby removing any need to preserve EPBs.

2.1 Contracting out and Defined Benefit (or salary-related) schemes

Contracting out in its present form was introduced in April 1978, under the *Pensions Act 1975*, which introduced the State Earnings Related Pension (SERPS). Originally, employers could only contract out of SERPS if they provided Defined Benefit (DB) schemes and a Guaranteed Minimum Pension (GMP) which at least equalled the SERPS they would have earned had they not been contracted out. They were told how much their additional pension would have been but a contracted-out deduction, equal to the GMP they should receive from their occupational scheme, was made before payment.

The *Pensions Act 1995* broke the link between SERPS and contracted-out pension schemes with effect from April 1997. Contracted-out salary-related schemes (COSRS) do not have to provide GMPs in respect of benefits accrued after 1997, but they still have to provide them in respect of benefits accrued between 1978 and 1997. A contracted-out salary-related scheme (COSRS) must now provide benefits which are broadly equivalent to or better than a statutorily defined Reference Scheme Test (RST).[3] A scheme that passes the RST is "expected (but not guaranteed) to provide pensions broadly equivalent to or better than the benefits that the individual is giving up from contracting out of S2P".[4]

GMP conversion

The Government has described the GMP as a "continuing source of complexity, particularly on wind-up and over transfers".[5] The *Pensions Act 2007* therefore contained provision to allow contracted-out Defined Benefit schemes to convert GMPs into scheme benefits provided they meet certain conditions.[6] The Explanatory Notes say:

1 Pension Service, *Contracted-out pensions,* September 2010, p7-8
2 Office of Tax Simplification, Review of tax reliefs – final report
3 Section 12B *Pension Schemes Act 1993*
4 DWP, *Pensions Bill – Impact Assessment*, footnote to para 2.34
5 DWP, *Security in retirement: towards a new pensions system*, Cm 6841, May 2006, para 2.29
6 Section 14

> 71. In the White Paper, the Government proposed to introduce a facility for schemes to convert members' rights to a guaranteed minimum pension into rights to an ordinary scheme pension, calculated under the scheme's own rules, subject to certain safeguards to protect the members' interests. Each member's post conversion benefit would be required to be at least as actuarially valuable as their rights immediately prior to conversion.
>
> 72. By conducting a guaranteed minimum pensions conversion exercise, a scheme may be able to adopt a unified and streamlined benefit structure which will enable administrative savings to be made as well as offering advantages to members (in terms of understanding their rights in the scheme and being able to transfer them to other schemes more easily). It would be for scheme trustees to decide whether they wished to make use of this facility.[7]

The *Occupational Pension Schemes (Contracting-out) (Amendment) Regulations 2009* (SI 2009/846) set out how actuarial equivalence is to be determined for the GMP element and the new scheme benefits and the circumstances in which a survivor's benefit must be payable from the converted GMP benefits.[8]

In its response to the consultation on these regulations, the Labour Government said that it hoped the measure would be beneficial for schemes in the longer term:

> In the short term many schemes may not wish to use the conversion facility, but in the longer term this optional measure may be beneficial for schemes restructuring their pension arrangements. There are no current plans to make conversion of GMPs a statutory requirement.[9]

The costs and benefits of conversion would vary according to the circumstances of the scheme:

> 4.44 Whilst costs and benefits will vary significantly according to the circumstances of the particular scheme, for the purposes of making a broad indicative estimate of the possible effects of this reform, we have assumed an average initial cost of £7,000 for smaller schemes and £12,000 for larger schemes. Using an assumption that 25-50 per cent of schemes may choose to convert their GMPs, the total initial cost across all schemes is estimated to be between £11m and £22m, with a total annual cost saving of £6m to £13m.[10]

Interaction with the State Pension

The state is responsible for providing some post-inflation retirement-proofing for GMPs through the Additional State Pension (ASP). When someone reaches State Pension age, the state calculates the ASP someone in contracted-out employment would have earned, had they been contracted-in. It then checks (with HMRC) to see whether they have a GMP accrued through contracted-out employment between 1978 and 1997. If they do, the amount of the GMP is compared with the amount of ASP and the lower is deducted from the

7 Explanatory Notes. *Pensions Act 2007*

8 Explanatory Memorandum, para 2.1

9 Guaranteed Minimum Pension (GMP) Conversion. Government response to the consultation. The Occupational Pension Schemes (Contracting-out) (Amendment) Regulations 2009; January 2009

10 Explanatory *Memorandum to the Occupational Pension Scheme (Contracting-out) Amendment Regulations 2009* (2009/846)

retirement pension. This is called the "contracted-out deduction."[11] On 16 December 2008, the Labour Government announced that overpayments had been made to members of public service pension schemes as a result of "incorrect indexation of an element known as the Guaranteed Minimum Pension or GMP."[12]

If a scheme cannot pay a person the pension they are owed, it may be possible for them to be 'bought back' into the State Second Pension. This is a process known as "deemed buyback".[13]

2.2 Contracting out and Defined Contribution (money purchase) schemes

The *Social Security Act 1986* introduced changes to SERPS and contracting out from April 1988. In particular, contracting out in Defined Contribution (DC) and appropriate personal pensions (APPs) was permitted and, indeed, encouraged. Prior to April 1997, a "minimum payment" ("minimum contribution" in the case of APPs) equal to the contracted-out rebate had to be made to the scheme. The benefits secured by those payments were called "protected rights" and had to meet certain conditions:

> Those rules are, first, that protected rights are invested only in certain specified products; secondly, that they are only transferred to schemes that are contracted out; thirdly, that annuities purchased with the protected rights must be calculated on a unisex basis, and fourthly, that the protected rights have to provide for a survivor benefit if a scheme member is married or a civil partner at the time that an annuity is purchased.[14]

Since 6 April 1997, 'appropriate age-related percentages' have been payable to a COMP scheme. They are paid partly by the employer and partly by the State. These appropriate age-related percentages can only give rise to protected rights. A flat-rate, equal to the National Insurance rebate, is paid by the employer. The difference between this and the full age-related percentage is paid by HMRC directly into the COMP in a single annual payment.[15]

The *Pensions Act 2007* contains provision to abolish the contracting-out option for DC schemes in the future. This is expected to happen from 2012. The rules on "protected rights" are also to be abolished (see section 3 below).

Interaction with the State Pension

As DWP explains, the way in which contracted-out money purchase schemes interact with the state scheme changed in 1997:

> <u>Pre-April 1997 rights</u>
>
> Contracting out for DC schemes was first introduced in 1988 and a person who was contracted-out pre-1997 is still treated as having an entitlement to the State Additional

[11] This issue is covered in more detail Library Standard Note SNBT/2674, *State Second Pension: Contracted-out deductions.*

[12] HC Deb, 16 December 2008, c111WS. This issue is covered in more detail in Library Standard Note SNBT/4919, Public sector pension overpayments.

[13] *Pension Schemes Act 1993*, Schedule 2 (para 5 (3A)-(3E) and (4)

[14] Pensions Bill Deb, 1 February 2007, c235; DWP consultation document, 'Abolition of defined contribution (DC) contracting out: treatment of protected rights accrued in the past and proposed operational arrangements' September 2006, Annex A, para 6

[15] IDS Pension Service, *Pension scheme design*, (2010), para 8.31

Pension, so a mechanism exists to avoid double provision. This is catered for by the Contracted-Out Deduction (COD).

For DC pensions the COD is a notional amount which does not match the benefits which the protected rights may actually provide. For the purpose of adjusting their State pension entitlement, it treats a person contracted out through a DC scheme as though they had contracted out through a Defined Benefit occupational pension scheme and built up a Guaranteed Minimum Pension (GMP). This enables a definite and uniform method of calculation of the COD to be applied. When a scheme member dies, their survivor is entitled to all or part of the deceased member's State pension rights and where the member was contracted out-pre-1997, a COD is also applied to the survivor benefit.

Post April 1997 rights

From 6 April 1997 to 5 April 2002, those contracted out no long built up an underlying entitlement to Additional State Pension. However, from 6 April 2002, some members may built up residual rights to Additional Pension. CODs to not apply to any rights built up from 6 April 1997 (including any rights from 6 April 2002).[16]

2.3 Contracting out and "mixed benefit" schemes

From 6 April 1997, schemes have been able to have distinct sections where in one section liabilities for GMPs and reference scheme benefits can be retained and another in which protected rights are retained. Such schemes are known as contracted-out mixed benefits (COMB) schemes. DWP explains the various requirements a COMB scheme must satisfy as follows:

> (a) benefits under the final salary section must meet the reference scheme test and comply with the provisions relating to GMPs for benefits accrued before 6 April 1997;
>
> (b) benefits under the money purchase section must meet all the requirements relating to protected rights;
>
> (c) the whole scheme must meet the funding requirements of a final salary scheme; and
>
> (d) no member may be contracted-out under the final salary section and the money-purchase section at the same time. (section 149 PA and the Occupational Pension Schemes (Mixed Benefit Contracting Out) Regulations 1996).[17]

The abolition of contracting out for DC schemes (see below) will mean that "members of money purchase sections of COMBS will no longer be able to contract out."[18]

3 The future of contracting-out

DC schemes

The Pensions Commission, appointed by the Government in December 2002 with the remit of "keeping under review the adequacy of private pension saving in the UK, and advising on

[16] Guaranteed Minimum Pension (GMP) Conversion. Government response to the consultation. The Occupational Pension Schemes (Contracting-out) (Amendment) Regulations 2009; January 2009, p21-22

[17] Ibid, p23

[18] Ibid, p23

appropriate policy changes, including whether there is a need to 'move beyond the voluntary approach'", published its second report in November 2005.[19]

It proposed changes to the Additional State Pension. When the State Earnings Related Pension was introduced in 1978, the intention was that it should be earnings-related. When it was replaced by the State Second Pension in 2002, the intention was for it to become flat-rate over time. The Pension Commission recommended accelerating the speed at which it would become flat rate. It noted that this would have a knock-on effect on contracted-out rebates, leading them to decline in importance over time. It considered the gradual disappearance of the contracted-out/contracted-in system to be the most appropriate policy:

> Our preferred option for reform of the state system has implications for the contracted-out rebate. Since we recommend building on the existing two-tier BSP and S2P system, rebates will continue to be paid to employers and employees contracted-out of the S2P. But since we recommend freezing the Upper Earnings Limit for S2P accruals the importance of these rebates will decline over time. We believe this gradual disappearance of the contracted-out/contracted-in system is the most appropriate policy since:
> - The contracted-out/contracting-in choice has added complexity to the UK pension system and is poorly understood. Its application to personal pensions helped generate the pension mis-selling problems of the 1990s. And it requires the government to set a "fair" level of rebate: this is likely to turn out in retrospect to be either too high, in which case government has spent money unnecessarily, or too low, in which case people would have been better to stay contracted-in. It is not a feature of the pension system which we would recommend now if it did not already exist.
> - But we believe that its immediate abolition would accelerate still further the decline of employer DB pension provision.
> - And the Pensions Commission does not believe it prudent to argue that abolition of contracted-out rebates can provide resources to offset the costs of an immediate increase in state pension generosity. Such a policy would reduce national savings by reducing the pre-funding of pensions at precisely the time when demographic change makes some increase in the national savings rate desirable.[20]

It therefore recommended that the contracting out option for DC schemes be removed:

> We therefore recommend phase-out and simplification of the contracting-out rules rather than immediate abolition.
> - For Defined Contribution (DC) occupational schemes (where contracting in already dominates) and for personal pension schemes (where many industry experts are already advising customers to contract-in), we recommend that the contracting-out option be removed, with all people not in DB schemes becoming members of the S2P.
> - For DB schemes, we recommend the continuation of the contracting-out option for the foreseeable future. But we propose that this option be abolished by at the latest about 2030, the date around which, under our proposals, accruals to the S2P become entirely flat-rate.[21]

The Labour Government's May 2006 Pensions White Paper proposed abolishing the contracted-out option for Defined Contribution schemes.

---

19 Pensions Commission, A New Pension Settlement for the Twenty-First Century: The Second Report of the Pensions Commission, 30 November 2005

20 Pensions Commission, *Second Report,* November 2005, p26

21 Ibid, p27

> 2.10 Current trends would suggest that an increasing number of people with DC pensions are contracting back into the State Second Pension. There is also evidence that a growing number of providers have contracted policy holders back into the state scheme, unless the policy holder opts not to do so. Between 2001/02 and 2003/04 around 700,000 people in DC schemes contracted back into the State Second Pension.
>
> 2.11 The evidence that complexity is a key factor in putting people off any sort of long-term savings decisions is compelling. Elsewhere in this paper we have made clear the priority we place on tackling undersaving and encouraging personal responsibility by clarifying the key decisions people need to take in relation to their financial planning for retirement.
>
> 2.12 We want people to be clear on what they can expect from the State. In this context, we have decided that the current contracting out arrangements do not fit with the newly clarified environment in which we are asking people to take their savings decisions. People will not therefore be able to use personal accounts as a vehicle into which to contract out.[22]

It said this would:

- offer greater clarity for individuals, removing the difficult judgement to be made about whether they would be better off contracted in or contracted out;
- enable individuals to make informed decisions about their additional pension saving options by building on a clear foundation from the State;
- avoid the complex decisions for individuals and advisers that could arise from the introduction of a new scheme of personal accounts, if people were able to contract out; and
- reduce costs for providers by removing the associated regulatory complexity.[23]

The intention was to do this from the same time as the Labour Government intended to restore the link between the basic State Pension and earnings, i.e. probably 2012.[24]

Section 15 of the *Pensions Act 2007* provided for the "abolition of contracting-out on a Defined Contribution basis and the removal of certain rules applying to protected rights which will take effect from the abolition date" (probably 2012).[25] The exception to this was the rule on survivors' benefits, which was removed under the *Pensions Act 2008*.[26]

The then Parliamentary Under Secretary of State, Lord McKenzie, explained the Labour Government's approach:

> The *Pensions Act 2007* already contains provisions to abolish contracting out on a defined contribution basis, and we expect that change to take place in 2012. The Act also contains provisions to remove most of the rules concerning the use of protected rights already accrued at the point of abolition. The exception is the rule on survivor benefit. Currently, protected rights have to provide for a survivor benefit if a scheme member is married or a civil partner at the time the annuity is purchased. Following

[22] DWP, *Security in retirement: towards a new pensions system*, Cm 6841, May 2006

[23] Ibid, para 2.19

[24] Ibid, para 2.20 and 3.13

[25] Explanatory Notes to the *Pensions Act 2007,* para 272; See also DWP consultation document, 'Abolition of defined contribution (DC) contracting out: treatment of protected rights accrued in the past and proposed operational arrangements' (September 2006) and the Government Response (March 2007)

[26] See Part 3A of the *Pension Schemes Act 1993* as amended by section 100 *Pensions Act 2008*

> detailed consideration of the survivor benefit rule and the open market option review, we have decided to remove this rule too. That is what the new clause and associated amendments will achieve.
>
> The main changes are being made on the face of the Bill; however, we are also expanding a power in the Bill so we can make the necessary consequential amendments and ensure a smooth transition to the new arrangements. Removing the survivor benefit rule means that once contracting-out on a defined contribution basis ceases, there will be no requirements for how past protected rights might be used. This will mean greater clarity for individuals, who will be free to choose an annuity that is appropriate for their circumstances. At the moment, people have to buy an annuity that provides a survivor's benefit, even if that is not in their best interests; for example, if their spouse has a good pension in their own right.[27]

On 12 March 2010, the then Pensions Minister, Angela Eagle announced that the Labour Government intended to abolish contracting-out for DC schemes from 6 April 2012:

> The Minister for Pensions and the Ageing Society (Angela Eagle): I wish to announce to the House that I intend for contracting-out for defined contribution pension schemes to be abolished from 6 April 2012. The Pensions Commission recommended abolition of contracting-out on a defined contribution (personal or occupational) basis, as part of a programme of pension reforms. Abolition is a simplification measure: contracting-out for defined contribution schemes is a complex issue and it has become increasingly difficult to determine that a scheme member would be better off by contracting-out of the additional state pension. Section 15 of the *Pensions Act 2007* provides for the abolition of contracting-out from defined contribution pension schemes and, during its passage through Parliament, our stated objective was to abolish to this time scale. It is important to give pension schemes due notice and the pensions industry will welcome this certainty over the abolition date. My officials will continue to work to implement the changes in line with the above announcement in liaison with HM Revenue and Customs, the pensions industry and relevant public bodies such as the Financial Services Authority and the Pensions Advisory Service.[28]

The Conservative-Liberal Democrat Coalition Government also intends to abolish this option from 6 April 2012. The legislation enabling this change will not be brought into force until 2012.[29]

DB schemes

As regards Defined Benefit (DB) schemes, the Labour Government said that it did not intend to bring forward additional proposals to abolish DB contracting-out. This would be subject to ongoing review as part of the evaluation of the overall pension reform package:

> 2.22 In a DB scheme, the pension is calculated by reference to the individual's earnings, and employer and employee contributions are set at a level to fund the scheme benefits. Decisions on funding levels and contribution rates are taken on a long-term basis. Decisions on contracting out and joining the pension scheme are therefore usually more clear cut. The Pensions Commission recognised that the abolition of contracting out for DB schemes would be more likely to spur scheme closure and reduce national saving than to stimulate more saving. This is because it could require a major restructuring of scheme benefits and a revision of scheme rules.

---

[27] HL Deb, 14 July 2008, c1040

[28] HC Deb, 12 March 2010, c36WS

[29] DWP Press Release – 3 February 2011 – Quninquennial review of contracted-out rebate rates

> 2.23 The Pensions Commission concluded that, for DB schemes, rather than abolishing contracting out, it should be phased out by 2030 when the State Second Pension becomes flat rate, making the flat-rate element of the State Second Pension 100 per cent contracted in. However, we do not intend, at this stage, to bring forward additional proposals to abolish DB contracting out in the longer term. Instead, the long-term future of contracting out for DB schemes will be subject to ongoing review as part of the evaluation of the overall reform package.
>
> 2.24 We believe that abolishing contracting out for DC schemes and retaining it for DB schemes on the current basis strikes the best balance between the need to simplify the system, where possible, for individuals and schemes, and a desire not to disturb existing DB provision.[30]

The Office of Tax Simplification, set up to provide the Government with independent advice on simplifying the UK tax system, recommended that contracting-out should be abolished for all schemes from 2012:

> B.202 This relief is being withdrawn from 2012 for most pensions and is now only relevant for defined benefit schemes.
>
> B.203 We recommend that the relief be abolished for all schemes from 2012, as this would align the treatment of all schemes and provide a simplification for employers and employees that participate in more than one scheme.[31]

In Budget 2011, the Government said it would consult on options for state pension reform. This would include a proposal for a single tier pension. As this would entail the end of contracting out, the Government would investigate the potential impact on employees and schemes in both the private and public sectors:

> **1.129** The Government will simplify the state pension system so that it is fair and supports personal responsibility, and so that costs are sustainable, both today and for future generations.
>
> **1.130** The state pension system is complex. It is not clear to working-age individuals what they might receive from the state, in particular from the State Second Pension, making it difficult to plan retirement saving. **The Government will look to reform the state pension for future pensioners so that it provides simple, contributory, flat-rate support above the level of the means-tested Guarantee Credit.** DWP will shortly publish a Green Paper to consult on options for reform, which will include a proposal for a single tier pension, currently estimated to be worth around £140 a week. Moving to single tier provision would end contracting out for defined benefit pension schemes. In itself, this could bring significant simplification of the personal tax system. However, the Government will investigate the potential impact on employees and schemes in both the private and public sectors. The Government will honour contributions to the current system. Given longer-term pressures on the public finances, these reforms will be designed so as not to increase public spending dedicated to state pensions. Final proposals are subject to confirmation, including on affordability, and will reflect the projections set out in the Office for Budget Responsibility's forthcoming Fiscal Sustainability Report.[32]

This is discussed in more detail in Library Standard Note, SN/BT 5787 *State Pension reform.*

---

[30] DWP, *Security in retirement: towards a new pensions system*, Cm 6841, May 2006

[31] Office of tax simplification, Review of tax reliefs – final report

[32] HM Treasury, Budget 2011,

Responses

Professional Pensions reported concerns among some pension experts regarding the possible impact of abolishing contracting-out for DB schemes:

> Pension experts believe extending the abolition of contracting out to DB schemes would kill the financial incentive companies have to keep schemes open - spelling an end to final salary arrangements. KPMG pensions partner Mike Smedley said: "If it does happen it would push up company costs. They would have to pay the national insurance rebates and it would mean employees get hit in the pocket as well." Hargreaves Lansdown pension analyst Laith Khalaf said: "It would be a huge disincentive because the fact they get this break is probably a reason why many of them are still open.If you take that away, the costs are going to go up both for the employer and for the employees."
>
> Tax experts say it could also force schemes to change the benefits they provide. Aon Hewitt principal consultant Tony Baily said: "The contracting-out rebate helps companies meet the cost of providing their pension benefits. If a company doesn't do anything else, it's going to cost them more to provide the same level of benefit. Their main options are either reduce the benefits or ask members to pay more. In the current environment, they may well be looking to pass that cost onto members in the form of higher contributions or reduced benefits."[33]

On the other hand, the National Association of Pension Funds described the proposal to introduce a simpler and more generous state pension as a "massive step forward":

> For too long we have put up with one of the most complicated and meanest state pensions in Europe. This reform provides a clearer foundation for saving for old age. For the first time in a generation, people will know that it pays to save. The NAPF has been at the forefront of fighting for a better state pension system. This is a massive step forward for a cornerstone of the welfare state, and also helps those saving into a workplace pension to plan their retirement more clearly.[34]

4 Contracted-out rebates

HM Treasury's *Tax benefit reference manual: 2009-10 edition* provided the following explanation of the contracted-out rebate:

> 5.8 All contracted-out employees and their employers pay [National Insurance] contributions from the PT [Primary Threshold] to the ST [Secondary Threshold] respectively, but receive a contracted-out rebate, which is calculated on the amount of earnings between the lower earnings limit (LEL) and the UEL (Upper Earnings Limit). For employers, it is 3.7 per cent…for contracted-out salary-related schemes, and for contracted-out money purchase schemes and appropriate personal pensions the employers' rebate depends on the age of the employee. This means that contracted-out employees and their employers pay a lower rate of contribution between the LEL and the UEL, in recognition of the fact that they lose their entitlement to the earnings-related element of the State pension as a result of being contracted-out.

[33] Michael Bow, 'Budget 2011: Contracting out to be abolished – Update 4, *Professional Pensions,* 23 March 2011
[34] NAPF Press release, 23 March 2011, NAPF applauds simpler state pension promised in Budget

4.1 Rates for 2007-2011

The government sets the level of rebates periodically on the advice of the Government Actuary's Department (GAD).[35] In the case of contracted-out salary-related schemes, this is required at least once every five years.

In March 2006, the Government set out the contracting-out rebate rates that would apply from April 2007 to 2012. For contracted-out salary-related schemes (COSRS), the rebate increased from 5.1% to 5.3% (3.7% for employers and 1.6% for employees). This was lower than the 5.8% rebate proposed by GAD.[36] However, the then Secretary of State for Work and Pensions, John Hutton said:

> In the present fiscal circumstances and given the current consideration of pensions policy outlined in the second paragraph to this report, I do not believe it would be appropriate to accept his recommendation. I have therefore decided to increase the reduction in the rate of National Insurance contributions to 5.3% of relevant earnings. I propose to maintain the reduction in the level of the primary (employee) contribution at 1.6% and to increase the reduction in the secondary (employer) contribution to 3.7%.[37]

For contracted-out money purchase schemes (COMPS), there is a flat-rate and age-related element to the rebate. The Government accepted GAD's recommendation that the flat rate rebate should be 3.0% of relevant earnings (1.6% for employers, 1.4% for employees). It also accepted that the age-related element should increase but that the cap on the rebate should be reduced from 10.5% of relevant earnings to 7.4%:

> In line with the Government Actuary's report, I have decided to increase the flat rate element for contracted out money purchase schemes to 3.0% of relevant earnings for members of contracted-out money purchase schemes. I propose to split the flat-rate rebate between the primary contribution at 1.6% and the secondary contribution at 1.4%. I have also decided to increase the level of the age-related element of the rebate as the Government Actuary recommends. However, I have also concluded that the rebates should continue to be subject to a cap. The current level of this cap is 10.5% of relevant earnings. I have now decided to change this to 7.4%, taking account of fiscal constraints and given, again, the current consideration of pensions policy outlined in the second paragraph to this report. Although I recognise that setting the cap at this level would affect some of those at ages below those currently affected by the cap, and reduce the rebate some people currently receive, I believe the considerations I have mentioned above are sufficiently persuasive to justify the change.[38]

For appropriate personal pension schemes (APPS), the age-related cap would reduce from 10.5% to 7.4%:

> As for members of contracted-out money purchase schemes, the Government Actuary's report sets out, by reference to the age of the individual, the percentage of relevant earnings which he considers reflects the cost of providing benefits of an actuarial value equivalent to the State Second Pension foregone.
>
> I have decided to increase the age related rebates for holders of appropriate personal pensions in line with the Government Actuary's report. However, as with contracted-out

---

35 *Pension Schemes Act 1993,* Section 42, 42B and 45A

36 Occupational and Personal Pension Schemes. Review of Certain Contracting-out Terms. March 2006. Cm 6758

37 Ibid, p26

38 Ibid

> money purchase schemes, these age-related rebates are subject to a cap, currently set at 10.5%. For the reasons given in relation to contracted-out money purchase schemes, I have decided to change the cap for appropriate personal pensions and set it too at 7.4%. Again, I recognise that setting the cap at this level would affect some of those at ages below those currently affected by the cap and reduce the rebate some people currently receive.[39]

Details of the current rebates are contained in the *Social Security (Reduced Rates of Class 1 Contributions and Minimum Contributions Order) 2006* *(SI 2006/1009)*.

From April 2010, the age-related percentages for people contracted-out into personal and stakeholder pensions were amended to reflect the fact that from this date, there would be two accrual rates for the State Second Pension rather than three.[40]

Comment

The Government's decision to set the contracted-out rebates for Defined Benefit schemes at a lower level than that recommended by GAD in 2006 has attracted some criticism. In debate in the House of Lords, for example, the then Conservative Treasury spokesperson, Baroness Noakes, described the *Social Security (Reduced Rates of Class 1 Contributions, Rebates and Minimum Contributions) Order 2006* as "mean-spirited":

> …through contracting out, the Government achieve a transfer of liabilities and risk from public funds to the private sector. In return for that transfer of risk, the Government pay the private sector via a system of national insurance rebates, so it is important that the price for that transfer is right. The Government say that the price for the next five years is to be 5.3 per cent with the reduced caps that the Minister explained, but no one else seems to agree with them.
>
> The Government Actuary has said that the rebate should be 5.8 per cent. The Government's decision to ignore the Government Actuary has been described by the actuaries Mercer as "the stealthiest of taxes"—and we have seen quite a few stealth taxes over the past few years, so that is quite an accolade. Actuaries Watson Wyatt have calculated that the new rebate will put another £1.5 billion of pressure on schemes, and another firm, Hymans Robertson, has calculated that £2 billion will be needed.
>
> The National Association of Pension Funds has noted that recent changes such as the introduction of the Pension Protection Fund have increased the costs of private pension provision and transferred additional risk from the Government. In that light, the NAPF believes that a fairer rebate level would be around 8 per cent rather than 5.3 per cent. The Association of British Insurers has pointed to the difficulty, which will be exacerbated by the new rebate levels, in advising employees whether to contract out or to remain contracted out.[41]

Lord Oakeshott, for the Liberal Democrats, was also critical:

> So the Government are deliberately, and against their own professional advice, setting the rebate at a level below that which the Government Actuary's department thinks is necessary to give an equivalent benefit to the state pension given up. In these

[39] Ibid

[40] *Pensions Act 2007 (Supplementary Provisions) (No. 2) Order 2009 (SI 2009 No. 3094)*

[41] HL Deb, 24 Mar 2006, c526

> schemes, are the Government not mis-selling contracted-out pensions and does not the inadequate increase in the rebate compound that?[42]

The Government said a review of the rates might be necessary following consultation on the May 2006 Pensions White Paper:

> However, the Pensions Commission, in its report "A New Pensions Settlement for the Twenty-First Century" has made a series of recommendations on the future of contracting out and the Government will be bringing forward its proposals in a White Paper in the Spring. Subject to that response, a further review of the reduced rates and rebates of National Insurance Contributions may be conducted earlier than would otherwise be necessary.[43]

In debate on the *Pensions Bill 2006-07*, the then Pensions Reform Minister James Purnell said the timing of the next GAD review would be kept under consideration.[44]

4.2 Rates for 2012-2017

The GAD's report on its quinquennial review of contracted-out rebates for 2012-2017 was published on 3 February 2011.[45] This explained that a number of factors had affected the cost of providing benefits equal to the value of the Additional Pension forgone by those who contracted-out on a Defined Benefit basis, including changes in the occupational pension landscape and government policy:

- the profile of members of private sector COSRS is changing as a result of continuing defined benefit scheme closures to new entrants and new accrual,
- the future existence of many schemes is now likely to be curtailed which might lead to different financial considerations than those that would apply to schemes which do not plan to wind-up,
- the operation of the Pension Protection Fund and the Employer Debt Regulations are now more clear,
- state pension age has been raised for many people, which reduces the amount of Additional Pension forgone by contracted-out members each year, and means that it is deducted later,
- expectations of members' longevity continue to rise,
- a new funding regime for defined benefit schemes is now fully in place (deriving from the Pensions Act 2004),
- typical investment portfolios for funded pension schemes have become more prudent,
- developing actuarial opinion,
- economic conditions are noticeably different, with possible implications for expected future investment returns and inflation, and

---

42 Ibid, c528

43 Ibid, p25

44 Pensions Bill Deb, 1 February 2007, c242

45 GAD and DWP, *Occupational and Personal Pension Schemes. Review of certain contracting-out terms,* February 2011

- the state Additional Pension will be indexed in future by reference to the Consumer Prices Index, rather than by the Retail Prices Index.[46]

For this review, GAD adopted a different approach to that taken in previous reviews:

> 3.2 At previous reviews, the Government Actuary suggested a single set of assumptions to value the benefits forgone by contracted-out workers, which led to a single proposed value for the defined benefit contracted-out rebate.
>
> 3.3 Until the last review, in 2005/06, the Secretary of State had always accepted the defined benefit contracted-out rebate proposed by the Government Actuary. However, at the last review the Secretary of State instead set the rebate at a somewhat lower level than that proposed, citing the state of the public finances.
>
> 3.4 I have adopted a different approach for this review. Following discussions with the Department for Work and Pensions and HM Treasury and after considering the responses to the public consultation, I am advising on three alternative valuation approaches. These show a range of possible outcomes for the defined benefit contracted-out rebate, so that the Secretary of State can make his decision on its value with a better understanding of the possible approaches, outcomes and implications.[47]

This was to propose three different approaches to valuing the State pensions foregone by contracted-out staff, each reflecting different valuation assumptions. At one end of GAD's proposed scale, the "gilts basis" is intended to allow a contracted-out scheme to provide benefits equal to those foregone with a high degree of certainty. This implies a relatively high rebate. At the other end, the "best estimates basis" is based on the assumption that the scheme pursues a strategy which is expected to be sufficient, half the time, to cover the cost of providing the benefits foregone. This implies a relatively low rebate:

> **Best estimate basis**
> 6.4 A 'best estimate' basis is intended to lead to a rebate which is considered, in broad terms, equally likely to deliver benefits which are more or less than the state second pension forgone as a consequence of being contracted-out. A rebate on a 'best estimate' basis uses estimates of the relevant assumptions which do not include any material margins of prudence and which are applied in a way which reflects the actual investment strategies adopted by such schemes. A rebate based on a 'best estimate' basis is expected to be sufficient, half the time, to cover the cost of providing benefits equivalent to the state second pension forgone by contracted-out workers.
>
> **Typical funding basis**
> 6.5 A 'typical funding' basis should include margins of prudence (relative to the 'best estimate' basis) which are consistent with the regulatory regime imposed by the Pensions Act 2004 and the Pensions Regulator's guidance. Thus, the rebate on the 'typical funding' basis represents the amount which funded defined benefit schemes would typically hold in practice in order to cover benefits of equivalent actuarial value to those forgone as a result of contracting-out (where the actuarial value is measured in the same way as technical provisions are calculated). A rebate based on 'typical funding' assumptions is expected to be more likely than not to be sufficient to cover the long-term cost of providing benefits equivalent to the state second pension forgone by contracted-out workers.

---

[46] GAD and DWP, *Occupational and Personal Pension Schemes. Review of certain contracting-out terms,* February 2011, p2-3
[47] Ibid

Gilts basis

6.6 The 'gilts' basis is intended to lead to a rebate which would allow a contracted-out defined benefit pension scheme to provide benefits equal to those forgone with a high degree of certainty, by investing in gilts. It does not mirror the cost of purchasing annuities from an insurance company, nor include any additional reserves of capital to meet extreme adverse outcomes. Thus, the rebate on the 'gilts' basis represents the amount which funded defined benefit schemes could hold in order to cover benefits of equivalent actuarial value to those forgone as a result of contracting-out, if they adopted a relatively low risk investment strategy based on gilts. Some describe this approach as 'self-sufficiency', since it may be possible at this level to avoid the need for extra funding in adverse times. A rebate reflecting the 'gilts' basis is expected to be sufficient on average to allow a scheme to adopt a low risk investment strategy and still cover the forgone state benefits without the sponsor having to provide additional financial support.[48]

GAD's proposed two sets rebate levels for 2012-17:

1.13 Based on the assumptions outlined in this report, the derived rebates are: Using state pension ages based on existing legislation:

- 4.9% on a 'best estimate' basis,
- 6.3% on a 'typical funding' basis, and
- 10.5% on a 'gilts' basis.

Using state pension ages based on expected revisions to existing legislation:

- 4.8% on a 'best estimate 'basis,
- 6.2% on a 'typical funding' basis, and
- 10.4% on a 'gilts' basis.

The reference to expected revisions to existing legislation refers to measures in the *Pensions Bill 2010-11* which would speed the increase to 66 in the State Pension age.[49]

The actual level of the rebate was a decision for the Secretary of State:

1.14 The decision to set the rebate for 2012 to 2017 rests with the Secretary of State. I suggest that he might reach his decision by:

- taking a view on the approach that fits the policy that it is desired to adopt for this review (for example, any of the three bases described above, or indeed any variant in between or outside the range offered here),
- considering, if appropriate, any refinements (for example, on state pension age, the extent (if any) to which guarantee aspects should be allowed for, margins, rounding, etc.), and
- determining the rebate and the split between employer and employee (noting that this aspect is outside of any considerations in this report).[50]

[48] Ibid, p14-15

[49] This is discussed in more detail in Library Standard Note SN/BT 2234 State Pension age.

In response, the Government explained that it had adopted the "best estimate" approach, resulting in a contracted-out rebate of 4.8%, the lowest of the rates proposed by GAD:

> **The Minister of State, Department for Work and Pensions (Steve Webb):** Later today the Government will publish an order to set the contracted-out rebate rate for salary-related pension schemes for the tax years 2012-13 to 2017-18. The new rate will be 4.8% and will be shared in the following way: 3.4% for employers (secondary class 1 contributions) and 1.4% for employees (primary class 1 contributions).
>
> Rebate rates for members of contracted-out pension schemes are reviewed at intervals of up to five years. It has been five years since the last review. The rebate is expected to reflect the cost of providing the benefits given up by individuals contracted out of the additional state pension.
>
> The Government Actuary has produced a report presenting three possible approaches to setting the rate. The Government have adopted the rate that was calculated using the Government Actuary's "best estimate" approach.[51]

This is a reduction compared to the level of the rebate in 2007-11 (5.3%).[52]

Initial comment

The *Financial Times* reported concerns in the industry at the Government's decision to take the lowest of the three options proposed by GAD:

> The move [...] follows a five-yearly review by the government actuary who told ministers that three approaches were tenable.
>
> One would have provided a combined employer and employee rebate of 10.4 per cent, allowing schemes to cover the cost with a "high degree of certainty, by investing in gilts". A middle range would have provided a 6.2 per cent rebate, but the government has gone for the lowest option, a combined 4.8 per cent, which the government actuary said was significant said was "expected to be sufficient, half the time, to cover the cost". The current combined rate is 5.3 per cent.
>
> The decision will cost pension schemes £600m a year but, as the government seeks to cut the deficit, it will save the Treasury, the same amount in rebates. Steve Webb, pensions minister, said the rebates came "at considerable cost to the taxpayer" and had to be "fair to all."
>
> John Ball, head of UK pensions at the consultants Towers Watson, said the decision was "another blow for employers sponsoring final salary pensions". He added: "They will be expected not only to underwrite the risk that benefits end up costing more than expected, but also to dip into their pockets straight away." He noted that Mr Duncan Smith, when leader of the opposition, attacked the "miserly" rebates Labour was then offering, branding them a "tax on the hard-pressed pensions sector". Mr Ball said the lower rebates would provide another reason for employers to get out of defined benefit pensions.[53]

---

50 Occupational and Personal Pension Schemes. Review of Certain Contracting-out Terms. March 2006. Cm 6758

51 HC Deb, 3 February 2011, c57-8WS

52 Occupational and Personal Pension Schemes. Review of Certain Contracting-out Terms. March 2006. Cm 6758

53 Nicholas Timmins, 3 February 2011, 'Pensions decision deals fresh blow to final salary schemes'

Joanne Segars of the National Association of Pension Funds described the reduction in the rebate as a "a stealth tax"

> The Government announced today that it would cut the contracted-out rebate for defined benefit ('final salary') pension schemes for 2012 to 2017 from 5.3% to 4.8%. Joanne Segars, Chief Executive of the National Association of Pension Funds (NAPF), said: "This is a stealth tax on people saving into a pension, and a further squeeze on the employers trying to help them. Cutting the value of the rebate will raise the operating costs of final salary schemes, and is likely to spur more employers to close these pensions to staff. The government should be supporting workplace pension schemes, not saddling them with extra costs."[54]

Debate on the SI

A draft statutory instrument (SI) to implement the new rates – the *Social Security (Reduced Rates of Class 1 Contributions and Minimum Contributions Order) 2011* – was laid before Parliament on 3 February 2011. The Order also contained details of rebates for members of contracted-out Defined Contribution schemes, even though the Government plans to abolish the contracting out option for these schemes from April 2012:

> The rebate Order contains figures to enable the calculation of rebates for members of defined contribution contracted-out schemes for the tax year 2012-13. While it is planned to abolish contracting out on a defined contribution basis from 6 April 2012, the legislation enabling this change will not be brought into force until 2012. As such the requirement to review defined contribution rebates every 5 years remains. As these figures are not expected to be used, they have only been provided for one tax year. [55]

The SI was debated in Parliament on 21 March. [56] Pensions Minister, Steve Webb, explained the Government's approach:

> For this report, unlike for previous ones, the Government Actuary has helpfully provided three alternatives for valuing the cost of the benefits forgone by contracted-out workers in salary-related schemes—a best estimate basis, a typical funding basis, and a gilts basis. Each of those approaches was carefully considered by the Secretary of State. To summarise, each approach is designed to provide the employer with a different level of guarantee that is sufficient to cover the cost of the additional state pension forgone.
>
> Taking into account the considerable cost to the taxpayer of providing reduced national insurance contributions, we have decided that the "best estimate" approach is the most appropriate to adopt. It provides a degree of certainty, which broadly means that the rebate provided is equally likely to be too much as too little in the long term in respect of the scheme providing benefits equivalent to the additional pension forgone. Furthermore, the assumptions on which the Government Actuary has based his "best estimate" approach are justifiable. The level of guarantee balances the needs of contracted-out employers and employees with obligations to the taxpayer. Although the other approaches would provide greater certainty for employers, that certainty would be at significant extra cost to the taxpayer.
>
> In his report, the Government Actuary considered the increases in state pension age already provided for in legislation and the Government's proposed increase in the state pension age to 66 from April 2020. To redress that factor, he provided two different

[54] NAPF Press Release, 3 February 2011, 'NAPF comment on contracting-out rebates'

[55] DWP Press release, 3 February 2011 – Quinquennial review of contracted out rebates

[56] *Draft Social Security (Reduced Rates of Class 1 Contributions, Rebates and Minimum Contributions) Order 2011*

> rates under each of the three approaches that he set out: one based on the existing arrangements for the state pension age; and one that takes into account the proposed changes on which the Government are currently legislating.
>
> We have decided that the proposed rise in state pension age to 66 needs to be reflected in the revised rebate rate. Hence, we have chosen the rate, under the "best estimate" approach, that takes that into account. That will mean a reduction in the rebate of national insurance contributions from April 2012 from 5.3% to 4.8% of relevant earnings. The balance of the rebate between employee and employer contributions will broadly be maintained—the level of the rebate on employee contributions will change from 1.6% to 1.4%, and the rebate on employer contributions will change from 3.7% to 3.4%.
>
> For personal pensions and money purchase occupational schemes, we have again accepted the Government Actuary's proposed rates of reduction in national insurance contributions and age-related payments, which would apply but for the plans to abolish contracting out for defined-contribution schemes in April 2012. That will mean that the flat-rate element for contracted-out money schemes will decrease to 2.4% of relevant earnings for members of those schemes. It will be split between employees at 1.4% and employers at 1.0%. We have also decided to maintain the level of the age-related rebate cap at 7.4%. As I mentioned earlier, the rates are being provided simply to meet an ongoing statutory requirement that will not lapse until the abolition of contracting out for DC schemes.[57]

Opposition pensions spokesperson, Rachel Reeves, asked the Minister what impact he had made "of the impact of the new level of rebate on contracting out as a whole".[58]

Mr Webb explained that the rebate was designed to be actuarially neutral:

> The fundamental issue that underlies a lot of what the hon. Lady says is whether the change means that a lot of people will stop contracting out—is it the final nail in the coffin of DB and so on? I understand that a contracted-out rebate is designed to be actuarially neutral. It is not designed to be a reward or a punishment; it is a quid pro quo. All the Government Actuary has done is said what is our latest estimate of the quid pro quo and also said, "You, as a scheme, contract out of the state scheme and provide benefits of at least equivalent value. What is the cost to you of doing that?" This is the answer to that question.

He said there was no evidence that incremental changes to the rebate were driving the trend away from DB schemes. This was being driving by other factors, such as longer life expectancies and the volatility of the costs on balance sheets. Schemes concerned about the reduced rebate rate had the option of reducing their accrual rates:

> Schemes could, if they wanted to—this is a substantive point—reduce their accrual rates within the scheme. If they are getting less rebate, they could say, "Oh well, we are getting less money coming in. Because of the promise we have to match from the state scheme, we will accrue in our scheme by a slightly smaller rate."[59]

---

[57] First delegated legislation committee, 21 March 2011, c3
[58] Ibid, c5-6
[59] Ibid, c8

5 The decision to contract out

5.1 Were people wrongly advised to contract out?

As explained above, since 1988, it has been possible to contract out into a personal pension. While a consumer is contracted out, the government pays some of the consumer's National Insurance contributions (known as a rebate) and income tax relief into a personal or stakeholder pension (this is sometimes known as an appropriate personal pension, or APP) of the consumer's choice. The consumer's pension provider invests this money to provide benefits at retirement instead of the benefits the consumer would have received from SERPS/S2P for the years they were contracted out.[60]

The 1985 White Paper, *Reform of Social Security. Programme for Action,* explained that the aim was to increase choice:

> 2.38 The right to a personal pension givens all employees a new dimension of choice. For the first time, everyone will be able to able to choose whether to stay in his employer's pension scheme, or fully in the state-earnings related scheme; or to rely upon a personal pension to give him additional income in retirement. The Government are determined that choice should be as wide as possible.[61]

To provide an incentive, the Government provided an extra rebate for a limited period for those becoming contracted-out for the first time:

> 2.30 The Government are anxious to give employees without their own pension and their employers a good incentive to start saving for their own pension. Savings through pension schemes already enjoy favourable tax treatment. But an additional incentive can be provided through the contracted out rebate.
>
> 2.31 All personal pensions and occupational pension schemes becoming contracted-out for the first time will therefore get an extra rebate until the end of 1992-93. It will be 2 per cent more of earnings than the standard rebate and will go to schemes and personal pensions becoming contracted-out during the five-year period from the start of the pension changes in 1988. If the 2 per cent works out at less than £1 a week, the extra rebate will be £1. This gives an added incentive to people on low earnings, among whom occupational pension coverage is now very poor.
>
> 2.32 The extra rebate will go into the occupational pension scheme or personal pension contributions. This will provide a genuine inducement to employees and employers to make pension provision for the first time.[62]

From 1993 onwards, the 2% incentive was withdrawn and rebates were reduced; although there was an extra rebate of 1% for those aged 30 and over. From 1997, National Insurance rebates became age-related and there were no government incentives.[63]

The view of successive Governments appears to have been that the decision to contract out was one for individuals. For example, in 1990, the then Conservative Parliamentary Under Secretary of State, Lord Henley, said the following:

---

60 FSA website, Results of the FSA's thematic work on contracting out of the additional State Pension

61 'Reform of Social Security', Programme for Action, Cmnd 9691, December 1985

62 Ibid

63 FSA website, Results of the FSA's thematic work on contracting out of the additional State Pension

> **Baroness Turner of Camden** asked Her Majesty's Government: What protection exists for individuals who accept the incentive to opt for a personal pension (as opposed to SERPS), but who later find that their expectations of a reasonable pension in retirement are likely to be disappointed.
>
> **The Parliamentary Under-Secretary of State, Department of Social Security (Lord Henley):** My Lords, individuals who choose to take out a personal pension are made aware that the amount that they will receive at retirement is dependent on the level of investment return achieved by the companies. After retirement part of the pension must be increased each year by the rate of price increases up to 3 per cent. If prices rise by more than 3 per cent, an addition is added to the individual's state retirement pension.
>
> **Baroness Turner of Camden:** My Lords, I thank the Minister for that reply. However, is he aware that personal pensions are currently being advertised with the statement that the incentive being provided could amount to up to £1,000? Is it not immoral to persuade people to gamble with their future in this way? What will it cost if people seek to rejoin SERPS at a later date? Will it not then have been a very costly exercise?
>
> **Lord Henley:** My Lords, it is entirely up to the individual to decide whether he or she wishes to take out a personal pension and to seek appropriate advice in his or her case. In the case of personal pension schemes which are investments as defined under the Financial Services Act, persons regulated by bodies under the Act have a duty to provide the best advice on such products. It is for the individual to make arrangement for obtaining any further advice that may be necessary in the light of changing circumstances.[64]

A Parliamentary Written Answer from 2005 suggested a similar position was taken by the Labour Government:

> Mr. Laws: To ask the Secretary of State for Work and Pensions what discussions he has had with the pensions industry about the number of people aged 53 years and over who remain contracted into the state second pension. [3576]
>
> Mr. Timms: My colleagues and I have had wide ranging discussions with representatives of the pensions industry and these have included issues that relate to the current contracting-out arrangements.
>
> It is for individuals to decide and keep under review whether it is in their best interest to contract out, taking into account their attitude to risk and their personal circumstances. The Department is however committed to ensuring that people are properly informed of the issues involved so that they can make a decision that best suits their needs. This includes the fact that when they reach the age at which the age-related rebate is capped, currently age 54, most personal pension holders would be better off contracting back in.[65]

In February 2005, in response to concerns raised by the consumers' organisation *Which?,* the FSA announced an investigation of the position of consumers who had contracted-out of SERPS/S2P. Its work would focus on two areas:

---

64 HL Deb, 12 February 1990, c1087

65 HC Deb 14 June 2005, cc 263-264W

- giving consumers relevant and accessible material to help them with the decision to contract out, remain contracted out, return to or remain in the state scheme – the 'forwards-facing' workstream; and

- investigating whether there had been widespread past mis-selling of APPs – the 'backwards-facing' workstream.[66]

As part of this work, the FSA commissioned some independent actuarial analysis from Oxford Actuaries Consultants (OAC). This examined the financial impact to date for consumers who have been contracted out of the additional State Pension compared to the position they would have been in if they had remained contracted in. It found that:

> on average, APP funds were estimated to provide a lower pension than consumers might otherwise have expected under the State scheme.[67]

However, a similar report commissioned by the Securities and Investment Board (SIB) in 1996 found that most consumers could expect to be financially better off if they contracted out of SERPS.[68]

The FSA said it was "important not to equate a potential underperformance with mis-selling." It went on to investigate the sales of policies used to contract-out of the State Second Pension (S2P), previously known as the State Earnings Related Pension Scheme (SERPS). While it concluded there was "no evidence of widespread mis-selling" although it did identify around "1.5% of sales (around 120,000) out of the eight million APPs sold where the consumers were above the industry-set "pivotal ages". It considered that "as many such sales were not typical practice at the time, it is possible that these consumers may have been wrongly advised to contract out."[69] The FSA fact sheet for those potentially affected said:

> We have found no evidence of widespread wrong advice to contract out. However, we have identified a potential problem with a small and specific group of people (around 1.5% of sales).
>
> These are people who were:
>
> - - advised to contract out between 1 July 1988 and 5 April 1997; and
>
> - - above a certain age – roughly 45 for men and 40 for women – at the time they contracted out, known as 'pivotal age'…
>
> These people may have suffered a loss as a result of wrong advice and may be eligible for compensation.[70]

The FSA advises people with concerns about the advice they were given to complain first to the firm that gave the advice. If unsatisfied with the response, they may be able to take a complaint to the Financial Services Ombudsman.[71]

---

[66] FSA website, Results of the FSA's thematic work on contracting out of the additional State Pension

[67] FSA website, *Contracting out of the additional state pension*, August 2005

[68] Ibid, para 3

[69] Financial Services Authority Press Release, FSA/PN/059/2007, Contracting out of SERPS/S2P: FSA finds no widespread mis-selling

[70] Financial Services Authority Factsheet, *The State Second Pension (formerly SERPS) – were you wrongly advised to contract out?*

[71] Ibid, p8

5.2 Should people be contracted out now?

Since 2004, FSA has produced information to help people decide whether to contract out.[72] A leaflet produced by the Consumer Financial Education Body (CFEB) in July 2010 says:

> **If you have contracted out**
>
> If you are contracted out through a personal or stakeholder pension, you should review your decision now.
>
> Your decision about whether to stay contracted out will depend on, among other things:
>
> - Your personal circumstances including how you wish to receive your benefits at retirement; and
> - Your attitude to investment risk.
>
> **How do you decide?**
>
> It is important that you compare the differences between being in or out of S2P and understand the risks.
>
> The decision to contract out is likely to be finely balanced in purely financial terms. However, people in older age groups, particularly those closer to retirement, are likely to be financially worse off by contracting out.
>
> By contracting out or staying contracted out, you are accepting the risk that your pension income could be lower than if you had stayed in S2P.
>
> If you dont want to accept this risk, contracting back in is likely to be the best option for you.
>
> You should make sure you review your decision every year. The decision you make this year will not affect past years in which you have contracted out.[73]

The Pension Service says that with contracting-out for Defined Contribution schemes ending in 2012, it is important for people to review their position:

> **Should I contract out (or stay contracted-out) of the State Second Pension?**
>
> Only you can make this decision. Contracting-out using an appropriate personal or appropriate stakeholder pension scheme raises different issues from contracting- out using an occupational pension scheme. With the ending of contracting-out in 2012 (except for salary-related pension schemes), it is important that you review your pension provision. This is because you will no longer receive any further National Insurance rebates from 6 April 2012. (These rebates are the amounts by which the employer's and employee's National Insurance contributions are reduced for employees who are members of a contracted-out pension scheme).
>
> See also page 13 about contracting-out with a personal or stakeholder pension and page 11 if you are contracted-out or thinking of contracting-out with a money purchase (also known as defined contribution) occupational pension scheme.[74]

---

72 *Results of the FSA's thematic work on contracting out of the additional State Pension*

73 CFEB, *The State Second Pension - should you be contracted out?* (June 2010).

74 Pension Service leaflet, Contracted-out pensions

6 Information and guidance

Further information and guidance on contracting out can be found at:

Pension Service

Pension Service, *Contracted-out pensions* (PM7) (October 2010)

Financial Services Authority

Financial Services Authority (FSA), Money Made Clear, *The State Second Pension – Should you be contracted out?* (July 2010)

FSA, *The State Second Pension (formerly SERPS) – were you wrongly advised to contract out?* (June 2008)

HMRC

HMRC's contracted-out guidance booklets can be found on its website.

These are:

- *Contracted-out Guidance for Salary Related Pension Schemes and Salary Related Overseas Schemes*. (CA 14C) (May 2010)
- *Contracted-out Guidance for Money Purchase Pension Schemes and Money Purchase Overseas Schemes* (CA 14D) (May 2010)
- *Contracted-out Guidance for Mixed Benefit Pension Schemes and Mixed Benefit Overseas Schemes* (CA 14E) (May 210)
- *Appropriate Personal Pension Scheme Manual Guidance for Scheme Managers* (May 2010) (CA16A)

There are also some useful FAQs for individuals.