Introduction

This factsheet explains the effect on the new State Pension of someone previously having been contracted-out of state earnings-related pension schemes. These schemes are collectively called ‘additional State Pension’ and comprise SERPS and S2P.

Introduction

1. Most people reaching State Pension age in the first couple of decades of the new State Pension, which starts on 6 April 2016, will have been contracted-out of the additional State Pension (SERPS, state earnings related pension scheme or S2P, state second pension) at some point. When people were contracted-out they either paid National Insurance contributions at a lower rate, or some of the National Insurance contributions they paid were used to contribute to a private pension instead of their additional State Pension. They will have been contracted-out through an occupational pension scheme where their pension was linked to their salary (defined benefit, DB); or through an occupational or personal pension scheme where contributions were invested and the final pension was determined by the outcome of those investments (defined contribution, DC). Most people – over 80% - would have received the full rate of new State Pension or more if their state pension had not been adjusted to take account of contracting-out.

2. The rules of contracting-out are very complex and the way they are reflected in the new State Pension is in line, in most respects, with these rules as they have stood from 1978. The Department for Work and Pensions is aware that where people have been told about contracting-out they have struggled to see how the rules are applied to them. This note describes:

- how contracted-out amounts are treated in the transition from the current scheme to the new State Pension and how National Insurance records up to 2015/16 are valued to create a Starting Amount;
- how contracted-out pensions are revalued from the point that someone leaves their contracted-out employment until they reach their State Pension age;
- the effect that the ending of the current scheme has on the uprating of additional State Pension and the Contracted-out Deduction.

3. It important to note that basic State Pension eligibility is not affected by adjustments for time spent contracted-out. Contracting-out adjustments are only made to additional State Pension entitlement in the current scheme.

4. Most of the rationale underpinning contracting-out is linked to the dynamics of the pensions landscape in the 1970s. To simplify understanding, this paper is mainly concerned with what will happen in the new State Pension
rather than why decisions were taken in the past. Some of the terms used such as “gross” S2P (State Second Pension) and S2P “Contracted-out Deduction” are there to simplify examples (the actual calculations can be more complicated and including them here would not aid clarity).

**Section A: How contracted-out amounts are treated in the new State Pension**

5. In determining a person’s new State Pension their National Insurance record will be calculated under the old and new scheme rules when the new State Pension starts in April 2016. The higher amount becomes a person’s Starting Amount.

6. Both these calculations will take into account periods when people were contracted-out of the additional State Pension (State Earnings-Related Pension Scheme or SERPS between 1978 and 2001/02 and State Second Pension or S2P from 2002/03). This reflects the fact that when people were contracted-out they either paid National Insurance contributions at a lower rate, or some of the National Insurance contributions they paid were used to contribute to a private pension instead of their additional State Pension. In other words they did not pay the State for SERPS or S2P while they were contracted-out.

7. To ensure these periods are reflected fairly, different methods are used to record contracting-out in the two calculations. This section is intended to explain why.

8. The following is an overview of the way that periods of contracted-out employment have been recognised over the years:

- **1978/79-1996/97 – DB Schemes - The Guaranteed Minimum Pension (GMP).** For this period if someone was contracted-out, a calculation of the amount of SERPS they would otherwise have built based on their earnings is undertaken (the resulting amount is called Gross Additional Pension). A calculation is then made of the amount of pension the DB contracted-out scheme is required to pay based on benefits broadly equivalent to the additional State Pension the person would have received had they not been contracted-out. This amount is the Guaranteed Minimum Pension (GMP). When the person reaches State Pension age, the GMP amount is subtracted from the Gross Additional Pension amount, the GMP amount is called the Contracted-out Deduction (COD). If there is any net additional State Pension after this calculation, the State pays this amount.

- **1988/89-1996/97 – DC Schemes –** For members of DC schemes, the COD is calculated as above - as if the individual was contracted-out in a DB scheme, although DC schemes are not required to provide a GMP – the final pension the person receives will depend on how well the money has been invested and/ or the annuity rates which apply.
• **1997/98-2001/02 – not recorded.** If someone was contracted-out during this period no Gross AP was recorded and no COD adjustment was made (the amounts would have just cancelled each other out which is not always the case with the GMP arrangements above).

• **2002/03-2015/16** – During this period low to moderate earners who are contracted-out benefit from the S2P “top-up”. This is achieved by assuming that the person has been contracted-in to SERPS (which is less than S2P for low to moderate earners) and then offsetting this amount from S2P. The difference, if any, is paid by the State as S2P top-up.

**The new State Pension Starting Amount**

9. On the introduction of new State Pension on 6 April 2016 two calculations will be undertaken:

- the current state pension calculation – which uses exactly the same rules as if someone has reached State Pension age in 2016;

- the new State Pension calculation – which calculates what entitlement someone would have if the new State Pension had been in place throughout their working life.

Both calculations take full account of people’s contracted-out record. But the way it is recorded is different in the two calculations.

**New State Pension: current state pension calculation**

10. The calculation comprises basic State Pension (and any amount from graduated retirement benefit which was in place from 1961 to 1975) plus:

   (1) Gross Additional Pension minus the Contracted-out Deduction for any contributions until 1996/97;

   (2) Any SERPS built up through being contracted-in between 1997/98-2001/02;

   (3) S2P for people who were contracted-in (plus any S2P top-up for low to moderate earners who were contracted out) between 2002/03 and 2015/16.

11. There is no need to factor anything in for the period 1997/98 to 2015/16 if the person had been contracted-out.

**New State Pension calculation**

12. The calculation is based on National Insurance qualifying years. The number of qualifying years a person has at the end of 2015/16 tax year is multiplied by 1/35th of the full amount of new State Pension up to the maximum of £151.25 (the illustrative amount of full new State Pension in
2015/16). Account has to be taken of any periods of contracted-out employment otherwise the person would get the benefit of the new State Pension valuation and any pension they built up as a result of being contracted-out.

13. For the period to 1997/98 there will be a Contracted-out Deduction as per paragraph 10(1). The periods 1997/98-2001/02 and from 2002/03 onwards also have to be taken into account as people who have been contracted-out would be building the private pension equivalent of Additional Pension in the contracted-out scheme. To reflect all periods of contracting out a “Rebate Derived Amount” is introduced into the new State Pension calculation and comprises the following:

2. A new notional deduction in respect of being contracted-out between 1997/98 and 2001/02 - this amount will be the amount of SERPS the person would have had if they had been contracted-in;
3. The deduction made from gross S2P in respect of being contracted-out from 2002/03 to 2015/16.

**Transition calculation - an example**

14. The example is of a man born in 1957 who will reach State Pension age on 6 April 2023 at age 66. He started to work at age 21 in 1978. For the calculation it is assumed that he has over 35 qualifying years and his Additional Pension is £2 a week for each year in which he worked (plus £0.85 a week per year in S2P top-up). It is also assumed that he has always been contracted-out in a Defined Benefit scheme.

<table>
<thead>
<tr>
<th>Period</th>
<th>Gross Amount of AP recorded in current scheme calculation</th>
<th>Net AP recorded in current scheme calculation</th>
<th>Rebate Derived Amount in nSP calculation</th>
<th>Estimated amount paid by private pension (RDA)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978-97</td>
<td>£38</td>
<td>£0</td>
<td>£38</td>
<td>£38</td>
</tr>
<tr>
<td>1997-02</td>
<td>£0</td>
<td>£0</td>
<td>£10</td>
<td>£10</td>
</tr>
<tr>
<td>2002-16</td>
<td>£12 (1)</td>
<td>£12</td>
<td>£28</td>
<td>£28</td>
</tr>
<tr>
<td>Total</td>
<td>£78</td>
<td>£12</td>
<td>£76</td>
<td>£76</td>
</tr>
</tbody>
</table>

Note (1) this amount is the S2P “top up” which provides low to medium earners with an uplift

**Current state pension calculation (Valuation 1)**

Using existing state pension rules as if this person had reached State Pension age at 2016 the calculation would be:

| Basic State Pension | £115.95 |
| Gross SERPS         | £ 38    |
Minus Contracted-out Deduction  -£38
“Gross” S2P         £ 40
Minus S2P “Contracted-out Deduction” -£28
Total Amount         £127.95

New State Pension calculation (Valuation 2)

New State Pension (35 qualifying years)  £151.25
Less Rebate Derived Amount       £ 76
Total Amount                      £ 75.25

As £127.95 is higher than £75.25, £127.95 is used as the Starting Amount.

Starting Amount = £127.95

15. In this case the current state pension calculation is the higher of the
two rates and becomes the Starting Amount - he receives a pension payable
from the State of £127.95 if he has no further qualifying years. The Rebate
Derived Amount of £76 will be paid by the private pension provider as part of
the overall pension payable by the scheme.

16. Some people will have Starting Amounts in excess of the level of the
full new State Pension as a result of the current scheme valuation described
in paragraph 10 above. These amounts, which are paid on top of the new
State Pension, are called “Protected Payments”.

Section B: DB Schemes - Guaranteed Minimum Pension: Revaluation

17. To ensure that the pension an individual builds up while they are at
work keeps its value in earnings terms until the person reaches State Pension
age, the additional State Pension is revalue by earnings each year. Defined
Benefit schemes are required to do the same in respect of GMPs.

18. However, this can change where a person leaves their DB scheme
before reaching GMP pensionable age (age 60 for a woman and age 65 for a
man). If the pension rights are preserved in the scheme, the GMP has to be
revalued up to their GMP pensionable age. Schemes could choose to
continue to revalue by earnings but some schemes opted instead for a fixed
rate revaluation. This can have a significant impact on a person’s Starting
Amount.

Fixed Rate revaluation - an example

19. The example is a man who was contracted-out for the 4 years between
1978/79 and 1982/83. His scheme opted to revalue his accruals at the fixed
rate factor in place at the time he left which was 8.5% year. He was then
contracted-in between 1983/84 and 1996/97. He had spells of self-
employment and contracted-in employment from 1997/98 until 2015/16. In this
case the current state pension calculation is the higher of the old/new scheme rules calculation. His Starting Amount would look like this at 2016:

<table>
<thead>
<tr>
<th>Pension Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic State Pension</td>
<td>£115.95</td>
</tr>
<tr>
<td>Gross SERPS 78-97</td>
<td>£55</td>
</tr>
<tr>
<td>GMP 78/83</td>
<td>£56</td>
</tr>
<tr>
<td>Additional Pension 98-2016</td>
<td>£30</td>
</tr>
</tbody>
</table>

Starting Amount = £145.95

20. The Gross SERPS of £55 comprises £17 from 1978/79 and 1982/83 and £38 from 1983/84 until 1996/97. When he left his scheme in 1982/83 his GMP was worth £17 but the fixed rate revaluation has increased this amount by 8.5% for each year from 1983/84 until GMP pensionable age. The resulting amount of £56 now exceeds the Gross SERPS for all of the period between 1978/79 and 1996/97.

21. Over time the price indexed Gross Additional Pension may exceed the £56 – which has been effectively frozen – and the person starts to see some price indexation. The Contracted-out Deduction can only be offset against additional State Pension built up before 1997 - the basic State Pension is unaffected. This feature of State Pension and contracting out is little understood and is likely to be of more interest as people become more aware of the new State Pension.

Section C: The ending of additional State Pension: effect on uprating

22. Once in payment, additional State Pension is “uprated” each year to ensure that it keeps its value in prices terms. Defined Benefit schemes are not required to uprate GMPs accrued between 1978 and 1987/88 but are required to uprate GMPs accrued between 1988/89 and 1996/97 up to a maximum of 3% of price inflation. DB schemes are required to uprate accruals from 1997/98 to 2004/05 by price inflation up to 5% and by a maximum of 2.5% for accruals from 2005/06 onwards.

23. In the current system Gross Additional Pension is adjusted by the Contracted-out Deduction at State Pension age and thereafter annually during retirement. The Contracted-out Deduction is uprated at the same rate as the GMP – so a Contracted-out Deduction which reflects GMPs built up between 1978/79 and 1987/88 is not increased and a Contracted-out Deduction reflecting GMPs built up between 1988/89 and 1996/97 is increased by price inflation up to a maximum of 3%.

The effect on uprating – an example

respectively. Assuming inflation is running at 2% the following calculation is made at the person’s first uprating:


Gross Additional Pension £18 increased by 2% £18.36
Contracted-out Deduction £18.00

1988/89-1996/97

Gross Additional Pension £20 increased by 2% £20.40
Contracted-out Deduction increased by 2% £20.40

25. The effect on the recipient of this additional State Pension/Contracted-out Deduction calculation can be virtually the same as if increases had been paid on their pre-1988 GMP. With the closure of the additional State Pension in 2016 it will no longer be possible to continue the calculation.

26. From April 2016 there is a legislative requirement to uprate the new State Pension by at least earnings. Protected Payments are uprated by prices.

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