

GOVERNMENT ACTUARY'S DEPARTMENT

Occupational and Personal Pension Schemes

REVIEW OF CERTAIN CONTRACTING-OUT TERMS

Reports by the Government Actuary and the Secretary of State for Social Security in accordance with sections 42(1), 42B(1) and 45A(1) of the Pension Schemes Act 1993 on the following draft Orders:

Social Security (Reduced Rate of Class 1 Contributions) (Salary Related Contracted-out Schemes) Order 2001

Social Security (Reduced Rate of Class 1 Contributions and Rebates) (Money Purchase Contracted-out Schemes) Order 2001

Social Security (Minimum Contributions to Appropriate Personal Pension Schemes) Order 2001

Cm 5076



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Presented to Parliament by the Secretary of State for Social Security by Command of Her Majesty March 2001

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Pension Schemes Act 1993

Contracting out: report by the Government Actuary in accordance with sections 42, 42B and 45A of the Pension Schemes Act 1993

To: The Right Hon. Alistair Darling MP Secretary of State for Social Security

1. Introduction

Legal basis 1.1 Section 42 of the Pension Schemes Act 1993 (the Act) requires a review to be carried out, at intervals of not more than five years, of the percentages specified in section 41 of that Act for the reduction in the Class 1 National Insurance contributions for members of salary related contracted-out schemes (COSRS). This reduction is known colloquially as the contracted-out rebate. The review should cover any changes in the factors affecting the cost to occupational pension schemes of providing benefits of an actuarial value equivalent to that of the earnings-related additional pension benefits given up by or in respect of members of COSRS.

1.2 Separate requirements exist for members of money purchase contractedout schemes (COMPS) under sections 42A and 42B of the Act. Section 42A provides for age-related rebates for members of COMPS, and gives power to make regulations regarding the manner in which and time at which payments of the rebates are to be made. Section 42B(1)(a) requires me to report on the age-related rebates required to reflect the cost of providing benefits of an actuarial value equivalent to that of the earnings-related additional pension benefits which are given up by or in respect of members of money purchase contracted-out schemes.

1.3 Section 45(1) of the Act, which relates to minimum contributions to appropriate personal pensions (APPs), specifies that the minimum contributions shall be the appropriate age-related rebates. Section 45A(1)(a) requires me to report on the age-related rebates required to reflect the cost of providing benefits of an actuarial value equivalent to that of the earnings-related additional pension benefits which are given up by or in respect of members of appropriate personal pension schemes.¹

1.4 The last reviews under the appropriate sections of the Act were laid before Parliament in March 1998 (Cm 3888). However, these reviews related only to certain tax changes announced in the July 1997 Budget and the level of expense allowance for COMPS. Those reviews in turn referred back to the reviews made in March 1996 (Cm 3221), which covered the five years from April 1997, for a wider consideration of factors in relation to contracting out. In particular, at the time that the 1998 reviews were laid before Parliament, no change was made in the level of the contracted-out rebate for COSRS.

1.5 The reduced rates of Class 1 contributions for members of COSRS which came into effect on 6 April 1997 are specified in section 41 of the Act, namely:

- (a) in the case of a primary (employee's) Class 1 contribution, a reduction in total contribution of 1.6 per cent of upper band earnings (that is, earnings between the lower and upper earnings limit); and
- (b) in the case of a secondary (employer's) Class 1 contribution, a reduction in total contribution of 3.0 per cent of upper band earnings.

Current levels of rebate and changes in legislation since previous reviews

¹Throughout this report, reference to contracting out in the context of APPs should be interpreted as relating to an earner who has minimum contributions paid to an APP and gives up certain entitlements to benefits from the state scheme.

The total contribution reduction for employee and employer combined was thus set at 4.6 per cent of upper band earnings. This is in line with my recommendations in Cm 3221 and Cm 3888.

1.6 Changes introduced by the Social Security Act 1998 and the Welfare Reform and Pensions Act 1999 permit the setting of primary and secondary thresholds for National Insurance contributions at levels other than the lower earnings limit. However the reductions in contributions for members of COSRS still apply to earnings between the lower and upper earnings limits.

1.7 The reductions in rates of contributions and rebates (paid directly to the scheme by the Inland Revenue)² for members of COMPS currently in force are set out in the Social Security (Reduced Rates of Class 1 Contributions, and Rebates) (Money Purchase Contracted-out Schemes) Order 1998 (S.I. 1998/945). This was approved by Parliament following the laying of the most recent review mentioned above (Cm 3888). It served to amend the Social Security (Reduced Rates of Class 1 Contributions and Rebates) (Money Purchase Contracted-out Schemes) Order 1996 (S.I. 1996/1055), which had been approved by Parliament following the laying of the earlier review (Cm 3221). The 1998 Order covered earnings in the three years from 1999-2000 to 2001-02 inclusive.

1.8 The rebates for members of APPs currently in force are set out in the Social Security (Minimum Contributions to Appropriate Personal Pension Schemes) Order 1998 (S.I. 1998/944). This was approved by Parliament following the laying of the most recent review mentioned above (Cm 3888). It amended the Social Security (Minimum Contributions to Appropriate Personal Pension Schemes) Order 1996 (S.I. 1996/1056), which had been approved by Parliament following the laying of the earlier review (Cm 3221). The 1998 Order covered earnings in the three years from 1999-2000 to 2001-02 inclusive.

1.9 The Child Support, Pensions and Social Security Act 2000 reforms the additional pension (commonly known as the State Earnings-Related Pension Scheme or SERPS) through the introduction of the State Second Pension. In particular, section 34 of that Act amends sections 42(1)(a)(ii), 42B(1)(a) and 45A(1)(a) of the Pension Schemes Act 1993 to alter the reference to the benefits given up as a result of membership of a contracted-out pension scheme or an appropriate personal pension. Reference is now made additionally to Schedule 4A to the Social Security Contributions and Benefits Act 1992 (the 1992 Act), which was inserted by section 31(3) of, and Schedule 4 to, the Child Support, Pensions and Social Security Act 2000. The effect is to stipulate that, following the introduction of State Second Pension in April 2002, in certain circumstances only a part of the State Second Pension will be given up by those contracted out, with the benefit being given up defined in paragraphs 6 and 7 of Schedule 4A to the 1992 Act.

1.10 This report covers my review of the rebate appropriate to persons contracted out through COSRS and COMPS (including, as appropriate, the relevant sections of any contracted-out mixed benefit schemes) and APPs in relation to the five year period commencing on 6 April 2002. Rebates appropriate for members of APPs and COMPS would also be appropriate where such schemes are stakeholder pensions, under the terms of the Welfare Reform and Pensions Act 1999, since I understand that you do not wish to exercise your powers under section 7 of that Act to specify different rates of rebates for APPs and COMPS which are stakeholder pensions.

²The Inland Revenue took over responsibility for functions connected with National Insurance contributions, including the payment of age-related rebates to COMPS and APPs, under the terms of the Social Security Contributions (Transfer of Functions, etc.) Act 1999.

2. General principles

2.1 Under the arrangements for contracting out after April 2002, the member of a contracted-out occupational pension scheme or an APP will give up entitlement to some of the additional pension benefits which would otherwise accrue. A full description of the benefits given up is set out in appendix A(i).

The Child Support, Pensions and Social Security Act 2000 (the 2000 Act) changes to additional pension - the reform of SERPS through the introduction of the State Second Pension – serve to increase the amount of additional pension accruing in each year for many members of the scheme, and to leave the amount of additional pension unchanged for other members. However, the benefit which members of contracted-out occupational pension schemes will give up is not, by-and-large, altered by the 2000 Act, and therefore contracted-out rebates proposed in this report for COSRS and COMPS reflect the same quantum of benefits as rates for the current quinquennium. For members of appropriate personal pension schemes the amount of benefit given up will represent the different accrual rates for the State Second Pension that will apply to different bands (bands 1, 2 and 3 in Schedule 4A to the Social Security Contributions and Benefits Act 1992 – also described in paragraph 9 of appendix A(i)). Where this report shows a single rate for the rebate for a holder of an APP as a proportion of upper band earnings, this is the rate that will apply to band 3, where accrual will continue, broadly, at the 20% rate. Twice the rate shown would apply to band 1 (where accrual is broadly at a 40% rate) and half the rate shown would apply to band 2 (where accrual is broadly at a 10% rate). The required minimum contribution will be calculated as the sum of the products of the rebate rates shown, the appropriate multiples and the earnings in each of the bands, and be paid by the National Insurance Contributions Office of the Inland Revenue to the APP scheme.

2.3 In considering the actuarial value of the additional pension benefit given up, assumptions must be made about the future levels of the following factors:

- (i) the yield on investments;
- (ii) the annual increase in the general level of earnings;
- (iii) the annual increase in the retail prices index; and
- (iv) rates of mortality for men and women, proportions married and the relative ages of husbands and wives.

2.4 The Pension Schemes Act 1993 requires a single rebate to be paid on behalf of members of COSRS. Therefore, in addition to the factors set out in paragraph 2.3, it is necessary to consider the proportions of men and women of different ages expected to be contracted out by this route, and their upper band earnings.

2.5 The final factor to be considered is the allowance for expenses likely to be incurred in providing a benefit of equivalent actuarial value to that given up under the three types of contracted-out arrangements.

2.6 Where appropriate, I have considered separately the factors for COSRS, COMPS and APPs.

2.7 The essential feature of the additional pension benefit is that it would be increased from the year of accrual to state pension age according to an index of earnings and from state pension age according to the increase in the Retail Prices Index. Contracted-out pension schemes are not required to underpin the benefits provided by the scheme with the additional pension benefit given up. COSRS are required to provide pensions broadly equivalent to, or better than, a reference scheme. COMPS and APPs are required to designate funds arising from payment of rebates as "protected rights" and to discharge liabilities in respect of such funds only in certain specified manners. However the requirements of the Act are that I consider the "factors ... affecting the cost of providing benefits of an actuarial value equivalent to that of the benefits which ... are foregone by or in respect of members of salary related contracted-out schemes."

3. Contracted-out salary related schemes

The Secretary of State may from time to time, and shall when required by subsection (2), lay before each House of Parliament

- (a) a report by the Government Actuary or the Deputy Government Actuary on
 - *(i) the percentages for the time being applying under section 41(1A) and (1B), and*
 - (ii) any changes since the preparation of the last report under this paragraph in the factors in his opinion affecting the cost of providing benefits of an actuarial value equivalent to that of the benefits which, under section 48A, are foregone by or in respect of members of salary related contracted-out schemes,
- *(b)*

Pension Schemes Act 1993, section 42(1)

Post-retirement net rate of 3.1 As noted above in paragraph 2.7, the benefit given up would have been return indexed from state pension age according to increases in the Retail Prices Index. In deciding on an appropriate net rate of discount some regard could be paid to the yield to be expected from investment in index-linked government securities. The annualized gross redemption yields on the FT-Actuaries index of such stocks with redemption dates more than five years into the future, assuming future price inflation of 5% a year, are illustrated in appendix B. This shows that these real annual gross redemption yields were broadly in the range 3.25% a year to 4.5% a year over the period from 1985 until 1997. Annualized gross redemption yields have currently fallen to previously unprecedented levels, of less than 2% a year. For more recent periods figures have been published assuming inflation of 0% a year. Interpolating between figures for the two different inflation assumptions suggests that on an assumption of inflation of 2.5% a year, consistent with the Chancellor of the Exchequer's inflation target, yields would currently be about 0.1% higher than the figures shown in appendix B.

3.2 Yields on comparable bonds whose return is linked to indices of price inflation issued by other governments around the world might be expected broadly to offer, in the long term, similar real returns and yields as UK government index-linked bonds. In making such comparisons, medium-term deviations of currency exchange rates from purchasing power parity and differences in definitions of price inflation in different countries have to be allowed for. As at the end of July 2000, yields on long-dated government index-linked bonds in different countries, excluding the UK, ranged between 3.5% a year and 4% a year. Over long periods when there was little or no inflation (over the medium and long terms at least), the yield available on fixed interest government securities in the United Kingdom averaged 3.70%.³ I propose, therefore, to use a yield after retirement relative to price increases of 3.5% a year.

3.3 However, the use of such a yield could disadvantage those who reached state pension age in the period before yields had reverted from their current levels towards this assumed long-term level. Hence I propose to use an annual rate of return after retirement relative to price increases of 2.0% a year for those reaching state pension age in 2002-03, increasing by 0.1% a year until it reaches an annual rate of 3.5% a year for those reaching state pension age in 2017-18 and subsequent years.

³See, for instance, "The risk premium on ordinary shares" by AD Wilkie, British Actuarial Journal, Volume 1, Part II.

3.4 This is lower than the rate I recommended at the last reviews (3.75% a year relative to prices for all years of reaching state pension age), especially for those retiring in the next few years. This reduction reflects to an extent lower yields on index-linked government stocks which have prevailed in the markets since 1997, which in turn has caused greater uncertainty about the level of yields which may be obtainable in future.

Pre-retirement net rate of return 3.5 Each year's future accrual of additional pension benefit will be indexed to state pension age in line with increases in an index of national average earnings as specified in the annual revaluation orders made under section 148 of the Social Security Administration Act 1992. Unlike increases after retirement in line with increases in the Retail Prices Index, there is no comparable asset class which provides returns linked to increases in national average earnings, and therefore no easily available market rate of return which can be determined. In addition, any use of figures for yields to redemption on bonds as a starting point for determination of an appropriate rate of return would need to take into account the need for income from such bonds to be reinvested at prevailing rates in the period prior to retirement. A further consideration is that the period until state pension age is, for many members of contracted-out arrangements, longer than the term of any bonds which might be available.

3.6 Many pension schemes choose to meet their liabilities to pay benefits which are linked to salaries by investing in assets such as equity shares and property. As well as offering the possibility of protection against changes in the real value of money over the long term, it is generally hoped that such assets will offer a higher rate of return than assets with a higher level of guarantee such as government bonds, albeit with potentially greater variability. The record of higher returns which have been available on such assets has been presented in many publications.⁴ A judgement has to be made as to the extent to which any such higher rates of return should be allowed for in determining the "actuarial value equivalent to that of the benefits which ... are foregone" by those who are contracted out. Although investment in such assets may affect the cost of providing a certain quantum of benefits, that could well be associated with higher variability or in some cases risk of default.

3.7 The history of increases in the index of average earnings relative to the Retail Prices Index is given in appendix C. This indicates that the long-term rate of increase in real earnings has often fallen between 1.5% and 2.5% a year since 1950. An assumed pre-retirement rate of return of 2% a year relative to earnings could, therefore, be expressed as the assumed ultimate figure of 3.5% a year for the average yield relative to prices based on investment in index-linked government bonds as in paragraph 3.3, less a 1.5% a year real increase in earnings. To the extent that average earnings increase more quickly than 1.5% a year relative to price increases, COSRS may well find that they are able to provide "benefits of an actuarial value equivalent to ... the benefit foregone" at a similar cost, by investment in the kind of assets with expected higher yields described in paragraph 3.6.

3.8 I propose, therefore, to use an annual rate of return before retirement relative to earnings increases of 2.0% a year.

3.9 The rate which I proposed and which was adopted in the review in 1996 was 2.25%. Following the change in the July 1997 Budget resulting in pension schemes no longer being able to reclaim tax credits on dividends payable by UK companies, I proposed a reduction in the assumed rate of return relative to earnings of 0.25% to 2%. However, at the time no change was made to rebates for COSRS. The rate currently proposed is in line with the rate I proposed in 1998.

⁴"Pension fund indicators – a long-term perspective on pension fund investment 2000" by Phillips & Drew, May 2000, for example.

Nominal rate of return

3.10 An assumption about future nominal rates of return is required only for the period of one year before retirement when there is no indexation of the accrued additional pension benefit. For this purpose I have assumed a rate of 6% a year. This is consistent with the assumed long-term real yield on index-linked gilts (3.5%) and the Chancellor of the Exchequer's inflation target of 2.5%.

3.11 This is lower than the rate proposed at previous reviews (8.0%), and this reduction reflects lower anticipated future inflation in the UK economy.

Longevity 3.12 Although the longevity of members of insured pension schemes has been studied by the Continuous Mortality Investigation Bureau (CMIB), a joint committee of the Faculty of Actuaries and the Institute of Actuaries, such schemes contain only a small proportion of the overall membership of occupational pension schemes. The Government Actuary's 1991 survey of occupational pension schemes indicated that only about one-tenth of the members of private sector occupational schemes were in insured arrangements. The Government Actuary's Department has been studying the mortality of the population of the United Kingdom and its constituent countries over a considerable period. Such work is the basis for the biennial official projections of the population of the United Kingdom and its constituent countries. The mortality of members of COSRS is frequently lighter than that of the general population. In calculating the proposed rebate for COSRS I have used 85% of the projected mortality used for the 1998-based projection of the population of the United Kingdom. A comparison, in the form of expectations of life, between the mortality rates proposed and those contained in the latest standard mortality tables published by the CMIB for use in connection with insured pension schemes (tables PML92 and PFL92) is shown in the table below. I have also assumed the same proportion of population mortality for the widows and widowers of members of COSRS.

Expectations of life at age 65

Year of attaining age 65, Y	M PML92 with projection by year of use U=Y	en Proposed rate – 85% of UK population mortality rates as projected by GAD (1998-based)	PFL92 with projection by year of use U=Y	men Proposed rate – 85% of UK population mortality rates as projected by GAD (1998-based)
2005	18.18	18.99	21.42	22.15
2020	19.40	19.80	22.48	22.85
2035	20.22	20.16	23.19	23.17

3.13 The rate proposed is lighter than that used for COSRS rebates in the previous reviews (95% of population mortality as used for the 1994-based population projections for England & Wales). This can be justified in the light of continuing mortality improvements observed during the 1990s and reflected in lighter mortality projected for future years. In addition, analysis of data relating to pensioners with contracted-out deductions suggests that their mortality is closer to 85% of population mortality than 95%.

Marital status

3.14 Part of the accrued additional pension will be paid to a surviving legal spouse at the date of death of the contributor in the circumstances outlined in appendix A(ii), reflecting the changes introduced by the Welfare Reform and Pensions Act 1999. The long-term financial estimates of the expenditure of the National Insurance Fund are based on projections of the population by legal marital status made within the Government Actuary's Department. I consider this to be the appropriate approach to valuing the additional pension benefit given up for the purpose of calculating the COSRS rebate. I have therefore used the latest projections of the 1996-based projection of the population of England and

Wales. I propose to assume that husband-wife age disparities are broadly in line with the experience for the population of Great Britain as revealed in the latest (1991) census.⁵ These changes reflect the use of the latest available evidence on these matters.

- Weights 3.15 The reduction in the Class 1 contribution for members of COSRS will continue to be a single percentage of upper band earnings, independent of sex and age. It is necessary, therefore, to weight the individual age- and sex-related rebates to obtain the appropriate average rebate. The necessary weights have been derived from the statistics of upper band of earnings of National Insurance contributors who are members of COSRS, analysed by age and sex. There has been a trend over time in the weights observed, caused by changes in the numbers contracted out and in the relationship between upper band earnings and individual earnings. It is appropriate to project the trend to the mid-point of the quinquennium 2002-03 to 2006-07. The weights which I have adopted for the period 2002-03 to 2006-07 are given in appendix D. The contribution reductions for those who remain in a new employment for two years or less are, in effect, cancelled due to the payment of contribution equivalent premiums (CEPs). In the last review it was considered that a satisfactory method of allowing for this was to exclude from the weights one-third of the earnings of those under the age of 25. This approximation is still considered suitable. The change in the weights reflects a greater proportion of the membership of COSRS who are women and gradual ageing of the membership, in line with the projection.
- **Contingency margin** 3.16 In past reviews a margin of 7.5% of the calculated rebate has been included to enable schemes with an older than average age distribution to contract out. The COSRS rebate will continue to be the weighted average of the age- and sex-related rebates and I have, therefore, considered it appropriate to retain this contingency margin.
 - **Expense loading** 3.17 At the previous review an allowance for expenses expressed as 0.2% of upper band earnings was incorporated into the rebate. Following the introduction of the State Second Pension, schemes will, as currently, have to satisfy the conditions in section 9(2B) of the Act, which includes the requirement, under section 12A of the Act, to provide regular actuarial certification that the pensions to be provided are broadly equivalent to or better than the pensions which would be provided under a prescribed reference scheme defined in section 12B of the Act (the "reference scheme test"). I have therefore considered it appropriate to retain the expense loading of 0.2% of upper band earnings.
 - **COSRS rebate** 3.18 Using the actuarial assumptions described above, the weighted rebate, including the expense loading and the contingency margin, is 5.1% of upper band earnings. I understand that the split of this amount into elements to be deducted from primary and secondary contributions will be addressed in the report you present to Parliament at the same time as this report.

3.19 The key actuarial factors in determining the COSRS rebate are the preand post-retirement net rates of return. The sensitivity of the calculated rebate (including the expense loading) to changes in these factors is indicated in the table below:

⁵"1991 Census, Household and Family Composition (10 per cent), Great Britain", Office of Population Censuses and Surveys and General Register Office for Scotland, HMSO, 1994.

Reduction in National Insurance contributions for members of COSRS as a percentage of upper band earnings (including allowance for contingency margin and expense loading)

Annual rate of investment return		tment return post-retiren asing period as described	
pre-retirement relative to earnings increases	3%	3.5%	4%
1.5% 2% 2.5%	5.7% 5.3% 4.9%	5.5% 5.1% 4.7%	5.2% 4.9% 4.5%

3.20 The key factors leading to the change in rebate proposed for the quinquennium 2002-03 to 2006-07 from that in the current quinquennium are set out in the table below:

Reduction in National Insurance contributions for members of COSRS as a percentage of upper band earnings (including allowance for contingency margin and expense loading)

Rebate adopted for quinquennium 1997-98 to 2001-02	4.6%
Effect of declining additional pension accrual rates Effect of changing mortality and other demographic assumptions Effect of changing economic assumptions pre-retirement rate post-retirement rate	-0.6% +0.2% +0.2% +0.2%
Effect of changing weightings	+0.5%
Proposed rebate for quinquennium 2002-03 to 2006-07	5.1%

4. Contracted-out money purchase schemes

The Secretary of State shall at intervals of not more than five years lay before each House of Parliament

- (a) a report by the Government Actuary or the Deputy Government Actuary on the percentages which, in his opinion, are required to be specified in an order under this section so as to reflect the cost of providing benefits of an actuarial value equivalent to that of the benefits which, under section 48A, are foregone by or in respect of members of money purchase contracted-out schemes,
- *(b)*

Pension Schemes Act 1993, section 42B(1)

Introduction 4.1 In Cm 3888 it was noted that whereas contracted-out rebates for COMPS for the quinquennium 1997-98 to 2001-02 had originally been set with regard to COMPS which faced expenses similar to those for appropriate personal pensions, changes in the nature of COMPS following 1997 made it appropriate to allow for a similar level of expenses as for COSRS in COMPS rebates. You indicated that you wish to continue with this approach.

4.2 In addition, I am advised that the requirements for equal treatment will require payment of the same rebates to men and women of the same age. This applies irrespective of the unequal treatment within the state system with respect to state pension age (to be equalized in the period up to 6 April 2020 as shown in appendix A(iii)) and, consequently, the accrual rates of the additional pensions. To provide equal rebates to men and women based on the average cost of benefits given up would make contracting-out unattractive to women. I have, therefore, calculated the age-related rebates using the female accrual rates and associated benefit structure for ages below one year before the current female state pension age of age 60, and the male age-related rebates thereafter.

Post-retirement rate of return relative to price increases	4.3 In paragraph 3.2 I noted that, in relation to COSRS, the post-retirement net rate of return could be set having some regard to the yields on index-linked government securities. I consider that the same factors apply in this case. Hence I propose to use an annual rate of return after retirement relative to price increases of 2.0% a year for those retiring in 2002-03, increasing by 0.1% a year until it reaches an annual rate of 3.5% a year for those reaching state pension age in 2017-18 and subsequent years.
Pre-retirement rate of return relative to earnings increases	4.4 The question of a suitable net rate of return was discussed in relation to COSRS. The same arguments apply to rebates to be paid to COMPS. I have considered it appropriate, therefore, to use the same pre-retirement net rate of return as that adopted for calculating the rebate in respect of COSRS. Accordingly I have used a net rate of 2% a year relative to earnings increases.
Nominal rate of return	4.5 Where an assumption about the nominal rate of return is required, I have again used 6% a year. In particular, sections 42A(2), (2A) and (3) of the Act provide for an appropriate flat-rate rebate to be paid during the financial year and the balance of the total age-related rebate later. Allowance has been made for the balance of the age-related rebate in excess of the flat-rate element to be paid to COMPS on average 12 months after the middle of the financial year to which they relate.
Demographic factors	4.6 If a married contributor to the additional pension scheme were to die before state pension age the spouse would be paid a pension at the level described in appendix A(ii). The benefit is not paid automatically and the conditions for payment are also described. Once the rebates are paid into a COMPS they are designated as "protected rights". On the death of a member before state pension age the protected rights must be paid wherever possible as a pension to a dependant. If there are no dependants, then the protected rights are paid as a single sum to the estate of the deceased member. Thus there is a difference of entitlement on death before state pension age between the additional pension benefit given up and that purchased with the rebate. This difference is not relevant to a person contracted-out through a COSRS because that scheme must satisfy the reference scheme test. If COMPS rebates made allowance for mortality before state pension age for those who survived to that age would be insufficient to provide a benefit of an actuarial value equivalent to the value of the additional pension benefit given up. That would be an unfortunate consequence and I have therefore omitted an allowance for mortality before state pension age in calculating the amount of the rebate. For ages above state pension age I have adopted the same mortality assumptions as those described for members of COSRS in paragraph 3.12.
	4.7 In assessing the actuarial value of the additional pension benefit given up, I have assumed that all COMPS members are married at the date on which state pension age is attained. The relative ages of husbands and wives adopted for COSRS have been retained for COMPS.
Expense loadings	4.8 As explained in paragraph 4.1, it is appropriate to include an allowance for expenses in rebates for COMPS of a similar magnitude as for COSRS. Thus I have made an addition of 0.2% of upper band earnings to the rates (as a proportion of upper band earnings) calculated on the assumptions above.
	4.9 Appendix E sets out the scale of age-related rebates for COMPS using the assumptions described above. The flat-rate element of the rebate for the quinquennium is determined as the lowest rebate applicable for any individual during the quinquennium. For this quinquennium it is the rebate applicable for someone aged 15 last birthday at 5 April 2002. At the youngest age, therefore, the entire rebate is paid during the financial year and there is no balance payable later.

4.10 The rates shown in appendix E are before the application of any "cap" on rebates. I understand that the question of such a cap will be addressed in the report which you will present to Parliament at the same time as this report.

5. Appropriate personal pensions

The Secretary of State shall at intervals of not more than five years lay before each House of Parliament

- (a) a report by the Government Actuary or the Deputy Government Actuary on the percentages which, in his opinion, are required to be specified in an order under this section so as to reflect the cost of providing benefits of an actuarial value equivalent to that of the benefits which, under section 48A, are foregone by or in respect of members of appropriate personal pension schemes,
- *(b)*

Pension Schemes Act 1993, section 45A(1)

- **Introduction** 5.1 The same considerations regarding requirements for equal treatment described in paragraph 4.2 apply to rebates for APPs as they do to rebates for COMPS and require payment of the same rebates to men and women of the same age. Hence, as with rebates for COMPS, I have calculated the age-related rebates using the female accrual rates and associated benefit structure for ages below one year before the current female state pension age of age 60, and the male age-related rebates thereafter.
- Post-retirement rate of
return relative to price
increases5.2In paragraph 3.2 I noted that, in relation to COSRS, the post-retirement net
rate of return could be set having some regard to the yields on index-linked
government securities. Again, I consider that the same factors apply in this case.
Hence I propose to use an annual rate of return after retirement relative to price
increases of 2.0% a year for those retiring in 2002-03, increasing by 0.1% a year
until it reaches an annual rate of 3.5% a year for those reaching state pension age
in 2017-18 and subsequent years.
- **Pre-retirement rate of return relative to earnings increases** 5.3 The question of a suitable net rate of return was discussed in relation to COSRS. The same arguments apply to rebates to be paid to insurance companies and other providers. I have considered it appropriate, therefore, to use the same pre-retirement net rate of return as that adopted for calculating the rebate in respect of COSRS. Accordingly I have used a net rate of 2% a year relative to earnings increases.
 - **Nominal rate of return** 5.4 Where an assumption about the nominal rate of return is required, I have again used 6% a year. In particular, allowance has been made for the rebates to be paid to providers on average 12 months after the middle of the financial year in which they were granted.
 - **Demographic factors** 5.5 As with COMPS, the factors set out in paragraph 4.6 imply that it is appropriate to make no allowance for mortality of members of APPs below state pension age. For ages above state pension age I have again adopted the same mortality assumptions as those described for members of COSRS in paragraph 3.12.

5.6 In assessing the actuarial value of the additional pension benefit given up, I have assumed that all APP members are married at state pension age. The relative ages of husbands and wives adopted for COSRS have been retained for APPs.

5.7 Some appropriate personal pensions will seek registration as stakeholder **Expense loadings** pensions under Part I of the Welfare Reform and Pensions Act 1999. In this case they will be bound by regulation 14 of the Stakeholder Pension Schemes Regulations 2000, which will have the effect of limiting the charges that can be deducted to 1/365% of the value of the fund for each day. This is the legal expression of the policy that for a stakeholder pension the only charge up to retirement age should be an annual charge levied as a proportion of the assets held in the fund, and that the maximum level of the annual charge is to be 1% a year. Given this, I propose to make a single allowance for expenses in recommending a rate of rebate for members of appropriate personal pensions, whether registered as stakeholder pension schemes or not, of a 1% a year reduction in the rate of return before retirement. In addition I propose to allow a 2% loading on the annuity factor derived from the mortality and interest rate assumptions described above in order to allow for the expenses of annuity purchase.

5.8 Appendix F sets out the scale of age-related rebates for APPs using the assumptions described above. As set out in paragraph 2.2, the rates apply to earnings in band 3, as defined in paragraph 9 of appendix A(i), where the State Second Pension given up by those contracted out into APPs will continue to have, broadly, a 20% accrual rate. A rate twice the rate shown will apply to earnings in band 1 (broadly 40% accrual rate) and one-half of the rate shown will apply to band 2 (broadly 10% accrual rate).

5.9 The rates shown in appendix F are before the application of any "cap" on rebates. I understand that the question of such a cap will be addressed in the report which you will present to Parliament at the same time as this report.

6. Fixed rate of GMP revaluation

6.1 While COSRS are not required to provide guaranteed minimum pensions (GMPs) for service after 5 April 1997, GMPs built up before that date continue to be subject broadly to the rules in force at that date.

6.2 Upon leaving contracted-out employment, one option for securing accrued GMPs is to revalue at a fixed rate of revaluation until the year before state pension age is attained (as opposed to revaluation in line with increases in national average earnings over that period). The relevant rates have been:

Date of leaving contracted-out employment	Fixed rate of GMP revaluation
Before 6 April 1988	8.5% a year
After 5 April 1988 and before 6 April 1993	7.5% a year
After 5 April 1993 and before 6 April 1997	7% a year
After 5 April 1997 and before 6 April 2002	6.25% a year

6.3 These rates have been set at 0.5% a year above the rate of increase in average earnings implied in the actuarial assumptions used to calculate the amount of the contribution reduction for members of COSRS. Hence I propose that the fixed rate of revaluation should be reduced to 4.5% a year for GMPs preserved from 6 April 2002, where 4.5% a year can be derived as the difference between the nominal rate of return proposed and the rate of return relative to earnings increases, plus 0.5%.

Christopher Daykin CB Fellow of the Institute of Actuaries

Government Actuary's Department

31 January 2001

Additional pension benefits under the State Earnings-Related Pension Scheme (SERPS) and State Second Pension

1. Since April 1978 employees who have paid Class 1 contributions on earnings above 52 times the lower earnings limit have been entitled to an earnings-related additional pension, generally referred to as the State Earnings-Related Pension Scheme (SERPS). Since 6 April 2000 employees earning between 52 times the lower earnings limit and the primary threshold for National Insurance contributions are treated as having paid Class 1 contributions and are, therefore, entitled to SERPS. Earnings between the lower and upper earnings limits (upper band earnings) in any tax year are revalued in line with the general level of earnings, up to the final relevant year, which is the year before that in which state pension age is attained. The revalued upper band earnings are then averaged over the period from age 16, or April 1978 if later, to the end of the year preceding state pension age. The retirement pension is payable from state pension age and is indexed after that age in line with the general level of prices.

2. Female state pension age will remain at 60 for women retiring up to 5 April 2010. For women retiring from 6 March 2020 onwards state pension age will be 65, as it is for men. Between those dates state pension age will increase by one month in every two month interval as set out in appendix A(iii). As a consequence, the accrual rates of female additional pension entitlements will be aligned with those for men.

3. Under the Social Security Contributions and Benefits Act 1992, additional pension will eventually be 20 per cent of surplus revalued earnings as defined above and may then be regarded as accruing uniformly over the working life between age 16 and the end of the tax year preceding state pension age. However, for those over age 16 when the accrual of additional pension commenced in April 1978, the working life for this purpose is taken as the years between April 1978 and the end of the tax year preceding state pension age.

4. For people reaching state pension age after April 1999, the accrual rate will be 25/N per cent in respect of earnings up to April 1988, where N is the number of tax years in the earner's working life from April 1978 to the end of the one preceding state pension age. However, the accrual rate in respect of earnings from April 1988 depends on the year in which state pension age is attained. For those retiring up to April 2009 there will be a phased reduction in the accrual rate from 25/N to 20/N per cent. For later retirements, the accrual rate for post-1988 earnings will be the ultimate rate of 20/N per cent.

Year of retirement	Percentage accrual rate for period 1988-89 onwards
2002-03	23.5/24
2003-04	23/25
2004-05	22.5/26
2005-06	22/27
2006-07	21.5/28
2007-08	21/29
2008-09	20.5/30
2009-10	20/31
2010-11	20/32
2027-28 and later	20/49

5. A summary of additional pension accrual rates is given in the table below.

6. In respect of contracted-out employment prior to 5 April 1997 the additional pension is reduced by a contracted-out deduction equal to the guaranteed minimum pension (GMP) that a contracted-out salary related scheme (COSRS) was required to pay to the employee as a result of contracted-out employment. Where the person had been contracted-out via a contracted-out money purchase scheme (COMPS) or an appropriate personal pension (APP), the contracted-out deduction in respect of contracted-out employment prior to 5 April 1997 was equal to the GMP that a COSRS would have been required to pay to a worker of the same age and sex who had had the same earnings.

7. The Pensions Act 1995 removed the requirement for contracted-out salary related occupational pension schemes to provide GMPs in respect of contracted-out service from April 1997 onwards. COSRS are required to satisfy the new scheme-based test by providing benefits which comply with the statutory standard. COMPS and APPs continue to contract out on the basis that the contributions made to the scheme in respect of employees are not less than the amount of the contracted-out National Insurance contribution reduction and provided that the schemes satisfy certain other requirements. Under the changes introduced by the Pensions Act 1995, contributors do not accrue any SERPS entitlement in respect of contracted-out earnings after April 1997.

Additional pension benefits under the State Second Pension and effect of contracting out

8. The Child Support, Pensions and Social Security Act 2000 (the 2000 Act) includes a number of changes to additional pension, which will subsequently be known as the State Second Pension. The main changes, which take effect from tax year 2002-03, are:

- the introduction of three different accrual rates on different bands of earnings;
- treating those earning between the annualized lower earnings limit (the "qualifying earnings factor" or "QEF") up to the "low earnings threshold" £9,500 a year in terms of 1999-2000 earnings as though they earned the low earnings threshold; and
- treating qualifying carers and people with long-term disabilities who have no earnings or earnings below the annual lower earnings limit, as if they had earnings at the level of the low earnings threshold.

The introduction of three different accrual rates affects the consideration of rebates for contracting out (for APPs at least), while the other measures – deeming of earnings of £9,500 for those with lower earnings and credits for people with long-term disabilities and carers – do not.

9. Following its introduction, State Second Pension will accrue on earnings (actual or treated as earned) between the lower earnings limit and the upper earnings limit. Earnings between the lower earnings limit and the upper earnings limit will initially be divided into three bands. Band 1 will be from the annual lower earnings limit to the low earnings threshold (LET). Band 2 will be from the low earnings threshold plus £1 to (3LET - 2QEF). This would be £21,600 in terms of 1999-2000 earnings. Band 3 will be from the top of the second band plus £1 to the upper earnings limit. The low earnings threshold will be increased each year in line with the annual increase in average earnings, including the period between 1999-2000 and 2002-03. Rounding rules will apply to the calculation of the low earnings threshold and the calculation of the top of band 2.

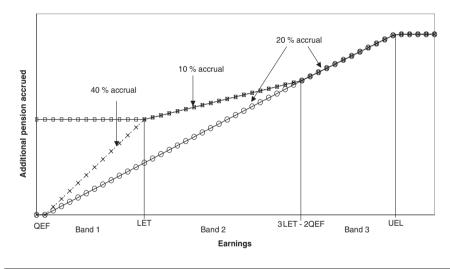
10. State Second Pension accrual rates will be double, half and equal to the current SERPS accrual rates on bands 1, 2 and 3 of earnings respectively. Thus, for example, for retirements in the year 2009-10 and later, the State Second Pension will be based on 40%, 10% and 20% of earnings in bands 1, 2 and 3 respectively.

11. After the State Second Pension is introduced, COSRS and COMPS rebates will continue to reflect the current SERPS accrual rates. This is set out in part III of Schedule 4A to the Social Security Contributions and Benefits Act 1992, which is inserted by section 31(3) and Schedule 4 of the 2000 Act. In particular, paragraph 8(3) of Schedule 4A stipulates that rebates will be based on actual earnings without any deeming of earnings to the level of the low earnings threshold as will occur for additional pension. Members of COSRS and COMPS earning below £21,600 a year (in terms of 1999-2000 earnings) will receive a State Second Pension top-up from the National Insurance Fund. This will be calculated by first working out the State Second Pension which would have been paid had these members not been contracted out. The top-up will then be determined by deducting from that amount the benefit upon which the rebate calculation is based, reflecting current SERPS accrual rates.

12. Following the introduction of the State Second Pension, appropriate personal pension scheme (APP) rebates will reflect the State Second Pension accrual rates structure. Rebates will be based on actual earnings. Those with an APP who earn less than the low earnings threshold in a year will receive a State Second Pension top-up from the National Insurance Fund based on the difference between the low earnings threshold and their actual earnings in a year.

13. The graph below aims to illustrate the pattern of benefits which will accrue under the State Second Pension, and the pattern of benefits given up by members of contracted-out pension arrangements.

State Second Pension accrual





APPENDIX A(ii)

Benefits for widow(er)s

1. An earnings-related additional widow(er)'s pension is payable in respect of earnings on which contributions were paid by the member of the additional pension scheme since April 1978. This additional pension accrues in the same way as the additional retirement pension described in appendix A(i). For deaths after April 1999, the "N" used to determine the accrual rate is the number of tax years from April 1978 to the end of the tax year preceding the member's death, subject to any future adjustment in respect of any credits to the member for incapacity and home responsibilities protection. The additional pension is reduced to reflect any guaranteed minimum pension (GMP) payable to the widow(er) in respect of a period of contracted-out employment or notional GMP in respect of membership of an appropriate personal pension or contracted-out money purchase occupational pension scheme. Indexation of the additional widow(er)'s pension is in line with the general level of prices.

2. The quantum of additional pension rights inheritable from April 2001 following the Welfare Reform and Pensions Act 1999 by age and status of surviving spouse of member with additional pension rights is shown in the table below.

Widow(er) over state pension age on bereavement	Paid in full until death
Widow(er) under state pension age but with qualifying children	Paid in full until death, remarriage before state pension age, or children ceasing to qualify. Where children cease to qualify and the widow(er) is aged 45 or over at that time, then payment will re-commence when the widow(er) reaches state pension age, provided the widow(er) has not remarried in the interim, and continue until death. Where children cease to qualify and the widow(er) is aged 55 or over at that time, the pension that re-commences at state pension age will be at the full rate that was payable initially on bereavement. Where children cease to qualify when the widow(er) is aged between 45 and 54, the pension re- commences at state pension age at a fraction of its former level, the fraction depending on the age at cessation of children's qualification. Where children cease to qualify and the widow(er) is aged under 45, no further benefit is paid
Widow(er) with no qualifying children, aged 55 or over on bereavement	No immediate pension, but a pension on reaching state pension age, provided that the widow(er) has not remarried in the interim, at the full rate continuing until death
Widow(er) with no qualifying children, aged between 45 and 54 inclusive on bereavement	No immediate pension, but a pension on reaching state pension age and continuing until death of a fraction of the full rate, provided that the widow(er) has not remarried in the interim, the fraction depending on the age at bereavement
Widow(er) with no qualifying children, aged under 45 on bereavement	No benefit

A qualifying child is one for whom the widow(er) is receiving child benefit.

In the table above "paid in full" or "full rate" means, in respect of State Second Pension accruals after 6 April 2002, up to 50% of the deceased person's additional pension rights accrued after that date, as this inheritance factor applies to all additional pension rights accruing following the introduction of State Second Pension.

Date of birth	State pension age (year. month)	Pension date	Date of birth	State pension age (year. month)	Pension date
06.03.50	60.0	06.03.2010	06.10.52	62.7	06.05.2015
06.04.50	60.1	06.05.2010	06.11.52	62.8	06.07.2015
06.05.50	60.2	06.07.2010	06.12.52	62.9	06.09.2015
06.06.50	60.3	06.09.2010	06.01.53	62.10	06.11.2015
06.07.50	60.4	06.11.2010	06.02.53	62.10	06.01.2016
06.08.50	60.5	06.01.2010	06.03.53	63.0	06.03.2016
06.09.50	60.6	06.03.2011	06.04.53	63.1	06.05.2016
06.10.50	60.7	06.05.2011	06.05.53	63.2	06.07.2016
06.11.50	60.8	06.07.2011	06.06.53	63.3	06.09.2016
06.12.50	60.9	06.09.2011	06.07.53	63.4	06.11.2016
06.01.51	60.10	06.11.2011	06.08.53	63.5	06.01.2017
06.02.51	60.11	06.01.2012	06.09.53	63.6	06.03.2017
06.03.51	61.0	06.03.2012	06.10.53	63.7	06.05.2017
06.04.51	61.1	06.05.2012	06.11.53	63.8	06.07.2017
06.05.51	61.2	06.07.2012	06.12.53	63.9	06.09.2017
06.06.51	61.3	06.09.2012	06.01.54	63.10	06.11.2017
06.07.51	61.4	06.11.2012	06.02.54	63.11	06.01.2018
06.08.51	61.5	06.01.2013	06.03.54	64.0	06.03.2018
06.09.51	61.6	06.03.2013	06.04.54	64.1	06.05.2018
06.10.51	61.7	06.05.2013	06.05.54	64.2	06.07.2018
06.11.51	61.8	06.07.2013	06.06.54	64.3	06.09.2018
06.12.51	61.9	06.09.2013	06.07.54	64.4	06.11.2018
06.01.52	61.10	06.11.2013	06.08.54	64.5	06.01.2019
06.02.52	61.11	06.01.2014	06.09.54	64.6	06.03.2019
06.03.52	62.0	06.03.2014	06.10.54	64.7	06.05.2019
06.04.52	62.1	06.05.2014	06.11.54	64.8	06.07.2019
06.05.52	62.2	06.07.2014	06.12.54	64.9	06.09.2019
06.06.52	62.3	06.09.2014	06.01.55	64.10	06.11.2019
06.07.52	62.4	06.11.2014	06.02.55	64.11	06.01.2020
06.08.52	62.5	06.01.2015	06.03.55	65.0	06.03.2020
06.09.52	62.6	06.03.2015	06.04.55	65.0	06.04.2020

Phasing of increase to 65 in female state pension age

Annualized gross redemption yields (GRY) on the over 5 years index-linked gilt index (assuming 5% inflation)



Source: FTSE Actuaries Government Securities indices

APPENDIX C

Real increases in earnings

Period		Annualized increase in Retail Prices Index (A)	Annualized increase in average earnings of all	Real earnings increase (1+B)/(1+A) – 1
from	to		employees (B)	
April 1963	April 1969	4.1%	6.9%	2.7%
April 1969	April 1979	12.1%	14.4%	2.1%
April 1979	April 1989	7.7%	10.1%	2.2%
April 1989	April 1999	3.8%	5.2%	1.4%

Period from to		Annualized increase in Retail Prices Index (A)	Annualized increase in average earnings of full- time adult male employees (C)	Real earnings increase (1+C)/(1+A) – 1
October 1948	October 1958	4.5%	6.4%	1.8%
October 1958	October 1968	3.1%	6.0%	2.8%
October 1968	April 1979	11.9%	14.2%	2.1%
April 1979	April 1989	7.7%	8.9%	1.1%
April 1989	April 1999	3.8%	4.4%	0.6%

Source: "The Abstract of Statistics for Social Security Benefits and Contributions and Indices of Prices and Earnings, 1999 Edition", Analytical Services Division, Department of Social Security

Weights for reductions in contributions for contracted-out salary related schemes

Age	Proposed weights		Weights used for current quinquennium		
	Men	Women	Men	Women	
16-19	0.000	0.000	0.003	0.001	
20-24	0.012	0.007	0.033	0.025	
25-29	0.037	0.024	0.077	0.055	
30-34	0.053	0.035	0.100	0.050	
35-39	0.093	0.073	0.099	0.044	
40-44	0.113	0.102	0.104	0.047	
45-49	0.102	0.097	0.107	0.047	
50-54	0.080	0.072	0.076	0.029	
55-59	0.054	0.033	0.055	0.017	
60-64	0.012		0.028	0.001	
65			0.002		
Total	0.557	0.443	0.684	0.316	
Weighted average age	42	41	41	38	

Proportions of earnings of COSRS members in each age band and sex

Rebates proposed for members of contracted-out money purchase pension schemes

Age last birthday on last day of preceding tax year	2002-03	2003-04	Tax year 2004-05	2005-06	2006-07
15	2.6%	2.6%	2.6%	2.6%	2.6%
16	2.6%	2.6%	2.6%	2.6%	2.6%
17	2.7%	2.7%	2.7%	2.7%	2.7%
18	2.7%	2.7%	2.7%	2.7%	2.7%
19	2.8%	2.8%	2.8%	2.8%	2.8%
20	2.8%	2.8%	2.8%	2.8%	2.8%
21	2.9%	2.9%	2.9%	2.9%	2.9%
22	2.9%	2.9%	2.9%	2.9%	3.0%
23	3.0%	3.0%	3.0%	3.0%	3.0%
24	3.1%	3.1%	3.1%	3.1%	3.1%
25	3.1%	3.1%	3.1%	3.1%	3.1%
26	3.2%	3.2%	3.2%	3.2%	3.2%
27	3.2%	3.2%	3.2%	3.2%	3.2%
28	3.3%	3.3%	3.3%	3.3%	3.3%
29	3.4%	3.4%	3.4%	3.4%	3.4%
30	3.4%	3.4%	3.4%	3.4%	3.4%
31	3.6%	3.6%	3.6%	3.6%	3.6%
32	3.6%	3.6%	3.6%	3.6%	3.6%
33	3.7%	3.7%	3.7%	3.7%	3.7%
34	3.8%	3.8%	3.8%	3.8%	3.8%
35	3.8%	3.8%	3.8%	3.8%	3.8%
36	3.9%	3.9%	3.9%	3.9%	3.9%
37	4.0%	4.0%	4.0%	4.0%	4.0%
38	4.1%	4.1%	4.1%	4.1%	4.1%
39	4.1%	4.1%	4.1%	4.1%	4.1%
40	4.3%	4.2%	4.2%	4.2%	4.2%
41	4.4%	4.4%	4.3%	4.3%	4.3%
42	4.6%	4.5%	4.4%	4.4%	4.4%
43	4.8%	4.7%	4.6%	4.5%	4.4%
44	5.0%	4.9%	4.8%	4.7%	4.6%
45	5.3%	5.1%	5.0%	4.9%	4.8%
46	5.5%	5.4%	5.3%	5.1%	5.0%
47	6.0%	5.6%	5.5%	5.4%	5.3%
48	6.8%	6.1%	5.7%	5.6%	5.5%
49	7.8%	6.9%	6.2%	5.8%	5.7%
50	9.0%	7.9%	7.1%	6.4%	5.9%
51	10.3%	9.1%	8.1%	7.2%	6.5%
52	11.2%	10.6%	9.3%	8.2%	7.4%
53	12.1%	11.4%	10.8%	9.5%	8.4%
54	13.3%	12.5%	11.6%	11.0%	9.7%
55	14.6%	13.6%	12.7%	11.8%	11.2%
56	16.0 %	14.9%	13.8%	12.9%	12.0%
57	17.4%	16.3%	15.1%	14.2%	13.2%
58	19.1%	17.8%	16.6%	15.4%	14.4%
59	11.5%	10.8%	10.1%	9.7%	9.3%
60	12.6%	11.8%	11.0%	10.3%	9.9%
61	13.7%	12.9%	12.0%	11.2%	10.6%
62	15.0%	14.0%	13.1%	12.2%	11.5%
63	16.5%	15.3%	14.4%	13.4%	12.5%

Percentage of upper band earnings, with no cap

Contracted-out rebates proposed for members of appropriate personal pensions

Percentage of earnings applicable to band 3 ("20% accrual rate band"), with no cap

Age last birthday on last day			Tax year		
of preceding tax year	2002-03	2003-04	2004-05	2005-06	2006-07
15	4.2%	4.2%	4.2%	4.2%	4.2%
16	4.2%	4.2%	4.2%	4.2%	4.2%
17	4.2%	4.2%	4.2%	4.2%	4.2%
18	4.3%	4.3%	4.3%	4.3%	4.3%
19	4.3%	4.3%	4.3%	4.3%	4.3%
20	4.4%	4.4%	4.4%	4.4%	4.4%
21	4.4%	4.4%	4.4%	4.4%	4.4%
22	4.5%	4.5%	4.5%	4.5%	4.5%
23	4.5%	4.5%	4.5%	4.5%	4.5%
24	4.5%	4.5%	4.5%	4.5%	4.5%
25	4.6%	4.6%	4.6%	4.6%	4.6%
26	4.6%	4.6%	4.6%	4.6%	4.6%
27	4.7%	4.7%	4.7%	4.7%	4.7%
28	4.7%	4.7%	4.7%	4.7%	4.7%
29	4.8%	4.8%	4.8%	4.8%	4.8%
30	4.8%	4.8%	4.8%	4.8%	4.8%
31	4.9%	4.9%	4.9%	4.9%	4.9%
32	4.9%	4.9%	4.9%	4.9%	4.9%
33	5.0%	5.0%	5.0%	5.0%	5.0%
34	5.0%	5.0%	5.0%	5.0%	5.0%
35	5.0%	5.0%	5.1%	5.1%	5.1%
36	5.1%	5.1%	5.1%	5.1%	5.1%
37	5.1%	5.1%	5.1%	5.2%	5.2%
38	5.2%	5.2%	5.2%	5.2%	5.2%
39	5.2%	5.2%	5.2%	5.2%	5.3%
40	5.4%	5.3%	5.3%	5.3%	5.3%
41	5.6%	5.5%	5.3%	5.3%	5.4%
42	5.7%	5.6%	5.5%	5.4%	5.4%
43	5.9%	5.8%	5.7%	5.6%	5.5%
44	6.1%	6.0%	5.9%	5.7%	5.6%
45	6.3%	6.2%	6.0%	5.9%	5.8%
46	6.5%	6.4%	6.2%	6.1%	6.0%
47	7.0%	6.6%	6.4%	6.3%	6.2%
48	7.8%	7.1%	6.6%	6.5%	6.4%
49	8.8%	7.9%	7.2%	6.7%	6.6%
50	9.9%	8.9%	8.0%	7.3%	6.8%
51	11.2%	10.0%	9.0%	8.0%	7.3%
52	12.0%	11.3%	10.1%	9.0%	8.1%
53	13.0%	12.1%	11.4%	10.2%	9.1%
54	14.1%	13.1%	12.2%	11.5%	10.3%
55	15.2%	14.2%	13.3%	12.4%	11.7%
56	16.5%	15.4%	14.3%	13.4%	12.5%
57	17.9%	16.7%	15.5%	14.5%	13.5%
58	19.5%	18.1%	16.9%	15.7%	14.6%
59	12.2%	11.4%	10.7%	10.2%	9.8%
60	13.2%	12.3%	11.5%	10.2%	10.3%
61	14.3%	13.3%	12.4%	11.6%	10.9%
62	15.4%	13.3 % 14.4%	13.4%	12.6%	11.7%
63	16.7%	15.6%	14.6%	13.6%	12.7%
	10.7 /0	10.070	1-1-0 /0	10.070	12.1 /0

REVIEW OF CERTAIN CONTRACTING-OUT TERMS

Reports by the Secretary of State for Social Security in accordance with sections 42(1)(b), 42B(1)(b) and 45A(1)(b) of the Pension Schemes Act 1993

Presented to Parliament by the Secretary of State for Social Security by Command of Her Majesty March 2001

Reports by the Secretary of State for Social Security in accordance with sections 42(1)(b), 42B(1)(b) and 45A(1)(b) of the Pension Schemes Act 1993

As required by the Pension Schemes Act 1993 (as amended by sections 137 and 138 of the Pensions Act 1995), I am laying my reports on the reduced rates and rebates of National Insurance contributions to be allowed in respect of members of contracted-out occupational pension schemes and appropriate personal pension schemes. These reports and the accompanying draft Orders deal with the reduced rates and rebates to have effect from 6 April 2002.

We remain committed to encouraging funded pension provision and to ensuring that the contracted-out reduced rates and rebates continue to make such provision an attractive option. Rebates reflect the fact that contracted-out occupational pension schemes and appropriate personal pension schemes provide an alternative to the state additional pension scheme (currently known as SERPS) and thereby relieve the State of part of the liability to provide income in retirement.

SERPS is being reformed through the introduction of the State Second Pension, also from 6 April 2002 (The Additional Pension (First Appointed Year) Order 2001 (S.I. 2001/208)). So my reports and the draft Orders are based on the benefits which will be given up by contracting out of the State Second Pension into an occupational pension scheme or an appropriate personal pension scheme.

Under the State Second Pension, low and moderate earners (those earning between the annual lower earnings limit of about £3,500 up to £21,600 a year in 1999 earnings terms) will build up more additional pension entitlement than they would have done under SERPS. In addition, low earners (those earning more than the annual lower earnings limit but less than £9,500 a year in 1999 earnings terms) will be treated for additional pension purposes as if they had earned £9,500. Extra help will also be available to those who contract out of the State scheme.

For those in an appropriate personal pension scheme all the extra help (apart from the boost to $\pounds 9,500$ for low earners) will be given through enhanced rebates. Someone earning less than $\pounds 9,500$ in 1999 earnings terms will receive a State scheme top-up, to reflect the boost for low earners.

Those in an occupational pension scheme will continue to receive a rebate calculated in the same way as it is currently calculated under SERPS. This avoids the need for employers to make changes to their current arrangements. All the extra help for low and moderate earners will be delivered through State scheme top-ups.

The reduced rates and rebates of National Insurance contributions set out in these reports will take effect from 6 April 2002. By then stakeholder pension schemes will have been in place for a year. I considered carefully whether it was appropriate to have different rebates for those contracted-out money purchase schemes or appropriate personal pensions that are set up as stakeholder schemes. I decided that, because the rebate represents the value of the State benefit foregone when someone contracts out of the State scheme, it should make no difference to the amount of the rebate whether the contracted-out scheme was set up as a stakeholder scheme or not. The Government Actuary has, therefore, reported on the same basis for all contracted-out money purchase schemes and for all appropriate personal pensions.

Pension Schemes Act 1993 section 42(1)(b) Reduced Rate of Class 1 National Insurance contributions for members of salary related contracted-out schemes

My first report, required by section 42(1)(b) of the Pension Schemes Act 1993 (as amended by section 137(4) of the Pensions Act 1995) concerns the amount of the flat-rate rebate payable to those in contracted-out salary related schemes. Currently section 41(1A) and (1B) of the Pension Schemes Act 1993 (which incorporates the percentage rebates from the last Rebate Order, the Social Security (Reduced Rates of Class 1 Contributions) (Salary Related Contracted-out Schemes) Order 1996 (S.I. 1996/1054)) provides for reduction by a total of 4.6% of the relevant earnings (split as 1.6% primary and 3% secondary). The relevant earnings are those earnings between the lower and upper earnings limits.

The Government Actuary has reviewed the cost of providing benefits of an actuarial value equivalent to the amount of State Second Pension foregone by those in contracted-out salary related schemes. As mentioned above, this amount is the same as the amount of SERPS that would have been given up if additional pension had continued to be calculated on the basis of SERPS. (The extra help for low and moderate earners in a contracted-out salary related scheme will be given by way of a state scheme top-up.)

Taking account of reductions in both pre- and post-retirement yield on investments, increasing longevity and the changes in membership of contractedout salary related schemes (higher average ages and more women members), the Government Actuary has recommended that the contracted-out rebate should be set at 5.1% of relevant earnings. This includes a contingency margin of 7.5% of the calculated rebate to enable schemes with an older than average age distribution to contract out and incorporates an allowance of 0.2% of relevant earnings for scheme expenses. I agree with the Government Actuary's recommendation. I propose to maintain the level of the primary (employee) contribution at 1.6% and to increase the secondary (employer) contribution to 3.5%.

(2) Pension Schemes Act 1993 section 42B(1)(b)

Determination and alteration of reduced rates of contributions and rebates for members of money purchase contracted-out schemes applicable under section 42A of that Act

My second report, required by section 42B(1)(b) of the Pension Schemes Act 1993 (as inserted by section 137(5) of the Pensions Act 1995) deals with the appropriate percentages of the relevant earnings which need to be specified for members of money purchase contracted-out schemes.

As indicated in the Government Actuary's report, I have decided to continue with the approach adopted in the last report in March 1998 (Cm 3888) of treating contracted-out money purchase schemes as incurring the same expenses as contracted-out salary related schemes. The reasons why my predecessor made the change in 1998 remain equally valid.

Taking this into account, the Government Actuary's report sets out, by reference to the age of the individual, the percentage of relevant earnings which he considers will now need to be invested to produce a benefit of an actuarial value equivalent to the State Second Pension foregone. The percentage is delivered in two parts: a flat-rate element (which takes the form of a reduction in Class 1 National Insurance contributions) and the balance of the total age-related rebate paid to the scheme after the end of the tax year to which it relates.

I have decided to increase the overall rebates for contracted-out money purchase schemes, in line with appendix E of the Government Actuary's report, as set out in the relevant Order. But the rebates should continue to be subject to a cap to restrain the costs to public finances. The current level of this cap is 9% of relevant earnings. I am mindful that retaining the cap at this level for the next quinquennium would affect some of those at ages below those currently affected by the cap, as a result of the general increase in the level of the age-related rebates. I have, therefore, decided to raise the cap on age-related rebates to 10.5% to avoid it affecting those currently untouched by it.

The flat-rate part of the rebate will be increased to 2.6% of relevant earnings for members of contracted-out money purchase schemes. I propose to split the flat-rate rebate of 2.6% between the primary contribution (1.6%) and the secondary contribution (1.0%).

(3) Pension Schemes Act 1993 section 45A(1)(b) Determination and alteration of rates of minimum contributions for those with appropriate personal pensions applicable under section 45 of that Act

My third report, required by section 45A(1)(b) of the Pension Schemes Act 1993 (as inserted by section 138(5) of the Pensions Act 1995) deals with the agerelated percentages of the relevant earnings which need to be specified for members of appropriate personal pension schemes.

The Government Actuary's report sets out, by reference to the age of the individual, the percentage of relevant earnings which he considers will now need to be invested to produce a benefit of an actuarial value equivalent to that of the State Second Pension foregone.

I have decided to increase the age-related rebates for holders of appropriate personal pensions, in line with appendix F of the Government Actuary's report, as set out in the relevant Order. Again, the rebates should continue to be subject to a cap to restrain the costs to public finances. For the reasons given in my second report above, I have decided to increase the level of the cap to 10.5%.

Under the State Second Pension, earnings between the lower and upper earnings limits are to be divided into up to three bands. Different accrual rates will apply to the part of an employee's earnings which fall into each of those three bands. Rebates to appropriate personal pensions will be calculated in the same way. The percentages set out in appendix F of the Government Actuary's report relate to earnings in Band 3 (between £21,600 in 1999 earnings terms and the upper earnings limit).

There are five Schedules to the draft Order, one for each of the five tax years covered by the draft Order. Each Schedule has a Table showing the age-related percentages for that year. Each Table has three percentages specified for each age. The percentages for earnings in Band 1 (from the annual lower earnings limit up to £9,500 a year in 1999 earnings terms) are twice what they would have been if SERPS had continued. The percentages for earnings in Band 2 (from £9,500 to £21,600 in 1999 earnings terms) are half what they would have been if SERPS had continued. And the percentages for earnings in Band 3 are the same as they would have been if SERPS had continued. This gives low and moderate earners a higher rebate than they would have received if SERPS had continued, reflecting the additional help that will be available to this group in State Second Pension. Higher earners will continue to receive broadly the same amount of rebate as they would have done if SERPS had continued.

Revaluation of Guaranteed Minimum Pensions

I propose also that the percentage rate by which guaranteed minimum pensions for those who leave pensionable service before normal pension age (currently 6.25% a year compound for those leaving since April 1997) should be changed to 4.5% a year compound for those who leave on or after 6 April 2002. This is in line with the Government Actuary's recommendation. An amendment to the existing regulation will be introduced in due course to provide for this.

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