These notes refer to the Child Support, Pensions and Social Security Act 2000 (c.19) which received Royal Assent on 28th July 2000

CHILD SUPPORT, PENSIONS AND SOCIAL SECURITY ACT 2000

EXPLANATORY NOTES

Part II: Pensions

Background – State Second Pension and Occupational and Personal Pensions

The current position

SERPS and contracting-out arrangements

326. The UK pension system combines a contributory state scheme, consisting of basic Retirement Pension* and Additional Pension, derived from the State Earnings-Related Pension Scheme (SERPS), with a private system of occupational and personal pensions*.

327. All employees and self-employed people, except the very lowest paid, pay (or are treated as having paid) National Insurance contributions* (NICs). These give entitlement to the basic state pension. In addition, employees – but not the self-employed – earn entitlement to an additional, second-tier pension (SERPS), unless they choose to "contract-out" of SERPS and join a pension scheme which gives them rights in place of their SERPS entitlement.

328. For those who are, or have been, members of SERPS, the amount of Additional Pension they will receive is based on the amount of their "surplus earnings" in the years since 1978 when SERPS was introduced. Surplus earnings are those between the Lower Earnings Limit* (LEL) and Upper Earnings Limit* (UEL). The surplus earnings are increased in line with average earnings to the year before a person reaches state pension age in order to maintain their value in earnings terms. The total amount is multiplied by an accrual rate of between 25% and 20% depending on the year in which the person reaches state pension age (for anyone reaching state pension age from 6 April 2009 onwards, the accrual rate is 20%). This amount is then divided by the number of years in the person's working life since 1978 (up to a maximum of 49 for those who reach state pension age from 2027) to give the annual amount of that person's Additional Pension derived from SERPS.

329. SERPS is solely an earnings-related scheme, with higher benefits accruing to those who have had higher earnings throughout their working life. Lower earners accrue lower benefits, and it is possible to have worked and paid NICs throughout a working life and still receive a combined basic and Additional Pension which is less than is available through means-tested benefits. Those who have had breaks in their employment history for periods of caring or disability can be similarly affected.

330. Employers may choose whether or not to provide an occupational pension scheme and whether to contract-out of SERPS. For those who are contracted-out of SERPS, a NI rebate is given in recognition of the fact that there is a reduced liability on the state.

331. A person contracted-out of SERPS may be a member of:

- a “salary-related” occupational pension scheme, where the pension received depends on the employee’s salary and service history. In such schemes employers and employees pay lower rate NICs;
- a “money purchase” based occupational pension scheme. The contributions and any NI rebate are invested and, on retirement, can be used to buy an annuity. The final pension received depends on the investment performance of the scheme and the annuity rates available at retirement. Employers and employees pay a reduced rate of NICs and an age-related payment, which is increased with the age of the member, is paid to the pension scheme by the Inland Revenue; or
- an “appropriate personal pension” (i.e. a contracted-out personal pension). In this case, employers and employees pay the full rate of NICs and an age-related payment is paid into their pension fund at the end of the tax year*.

332. Some occupational schemes are hybrid or “mixed benefit”, combining features of salary-related and money purchase schemes. All personal pensions are provided on a money purchase basis.

333. Occupational pension schemes which are contracted-out must satisfy conditions which are designed to ensure that employees in these schemes, who are benefiting from NI rebates, receive pensions from the scheme which at least equal what they would have received from SERPS.

334. Prior to April 1997, in order for a salary-related scheme to contract-out, it had to promise to provide a Guaranteed Minimum Pension (GMP), which is broadly equivalent to what the SERPS entitlement would have been had the individual not contracted-out.

335. From April 1997, contracted-out salary-related schemes have had to satisfy a scheme-based test (reference scheme test). This requires schemes to meet a statutory standard laid down in the Pension Schemes Act 1993. The scheme actuary will certify that the test is met if the scheme provides benefits broadly equivalent to, or better than, those of the reference scheme.

336. Employees who join occupational pension schemes which have not contracted-out of SERPS, or non-appropriate personal pension schemes, accrue SERPS benefits as well as benefits under the scheme, but they do not receive NI rebates.

Occupational and personal pensions regulatory framework

337. There is a framework designed to protect the interests of scheme members within which occupational and personal pensions have to operate. This includes provisions to ensure that those who leave schemes before retirement can transfer or preserve their accrued rights, that pensions in payment receive some protection against price increases, that schemes are properly run and assets safeguarded, and that the benefits scheme members expect to receive are secure.

338. The Occupational Pensions Regulatory Authority (Opra) was established by the Pensions Act 1995* to regulate key aspects of the occupational pensions framework. The sale of personal pensions is regulated by the Financial Services Authority* (FSA).

Recent developments

339. The Government’s proposals for the reform of the pensions system in Britain were set out in the Green Paper *A new contract for welfare: PARTNERSHIP IN PENSIONS* (Cm 4179), published in December 1998.

340. Key principles set out in the Green Paper were that the new pensions system should:

- improve pensions for low earners and carers by reforming SERPS with a more generous State Second Pension;

- introduce new stakeholder pensions for moderate and higher earners; and
- continue to support and strengthen the framework for occupational pension provision.

341. Some of the measures to achieve the above aims were introduced in the Welfare Reform and Pensions Act 1999*. These include the legislative framework for the introduction of stakeholder pensions. It is intended to implement stakeholder pensions from April 2001. These schemes will offer money purchase benefits to members, providing benefits related to the contributions paid by the members, together with the investment returns on those contributions (less charges). The charges will be subject to an upper limit.

342. Stakeholder pension schemes will be targeted at those with moderate earnings (around £10,000 to £20,000 a year) who want to save more for retirement but who do not have access to an occupational scheme and for whom many existing personal pensions can be unsuitable or expensive. They will be set up within an approved governance structure (the arrangements for the management and oversight of a pension scheme) and meet minimum standards intended to encourage more moderate earners to save for their retirement. However, everyone will be able to pay into such a pension scheme, regardless of whether they are in work or not.

343. The Welfare Reform and Pensions Act 1999 also included legislation on several detailed proposals on occupational and personal pension schemes which were contained in the consultation document *Strengthening the Pensions Framework* that accompanied the 1998 Green Paper.

The measures in the Act

State Second Pension

344. The State Second Pension will reform SERPS by boosting the Additional (second tier) Pension of low and moderate earners, and by providing Additional Pension for the first time for carers and some long-term disabled people with broken work records.

345. State Second Pension will be calculated by reference to the surplus in an individual's earnings factor. An individual's earnings factor corresponds to the whole of his earnings up to the Upper Earnings Limit and the surplus to the amount of those earnings between the Lower Earnings Limit and the Upper Earnings Limit.

346. The State Second Pension regime will provide for a new Low Earnings Threshold, which will be uprated in line with increases in national average earnings. In 1999/00 terms this Low Earnings Threshold will be £9,500. Anyone earning less than £9,500 but at or above the annual Lower Earnings Limit (£3,432 in 1999/00) will be treated for State Second Pension purposes as if they had an earnings factor of £9,500.

347. Carers, who have no earnings or earnings below the annual LEL, will be treated for State Second Pension purposes as if they had earnings of £9,500 for any year throughout which:

- they receive Child Benefit* for a child under 6;
- they are entitled to Invalid Care Allowance*; or
- they are given Home Responsibilities Protection* because they are caring for a sick or disabled person.

348. Those entitled to long-term Incapacity Benefit* or Severe Disablement Allowance* throughout a tax year will also be treated for State Second Pension purposes as if they had an earnings factor of £9,500 in that year, provided they meet a simple labour market attachment condition when they reach state pension age. This condition requires that they have worked and paid (or are treated as having paid) Class 1 National Insurance

contributions for at least one tenth of their working life since 1978, when Additional Pension was introduced.

349. There will be two stages to the State Second Pension. The first will be earnings-related for those earning above the Low Earnings Threshold. On the surplus in an earnings factor (actual or treated) of £9,500 (that is £9,500 less the prevailing annual Lower Earnings Limit), everyone will earn at least twice as much entitlement to Additional Pension as they did under SERPS. Where there is a surplus in the earnings factor corresponding to the amount of a person's earnings above £9,500 but not exceeding £21,600, the accrual rate on that surplus will be half what it would have been under SERPS. This will have the effect of recouping some of the increased accrual that everyone will receive on the surplus in the earnings factor of £9,500. However, all employees earning between the annual Lower Earnings Limit and £21,600 will receive more than they would have done under SERPS, with the largest proportionate gains going to those with the lowest earnings. Those earning £21,600 and above will receive the same as under SERPS.

350. In the second stage, to be introduced when stakeholder pension schemes have become established, State Second Pension will become a flat-rate scheme for those with a significant part of their working life ahead of them (for example, those aged under 45 at the point of change). In the second stage of State Second Pension, everyone who is contracted-in to the state scheme will be treated as if they had earnings of £9,500 (or corresponding to the prevailing Low Earnings Threshold at that time), regardless of the level of their actual earnings. Qualifying carers and long-term disabled people with broken work records will continue to be treated as if they had such an earnings factor. State Second Pension will be calculated for everyone by reference to the surplus in an earnings factor of £9,500. National Insurance rebates to those in contracted-out pension schemes will remain earnings-related.

Contracting-out arrangements

351. The Government views the contracting-out regime as central to the success of private pension provision and is keen to ensure that any changes made to the arrangements for contracting-out reflect the introduction of the State Second Pension, supporting and encouraging private pension provision.

352. When individuals contract-out they do so on the basis that their pension arrangements will give them, broadly speaking, what they would have received from the state had they not contracted-out. As there is a reduced liability on the state, individuals and employers running occupational schemes receive a contracted-out rebate, which is calculated by reference to the value of the state benefit given up. The Government Actuary conducts a review every 5 years to determine the appropriate level of the rebate. The next review, due to take place later this year, will consider the level of rebates with effect from 2002.

353. As the State Second Pension is designed to boost the pension of low and moderate earners, the Government intends to change the contracting-out arrangements to ensure that members of contracted-out pension schemes are not better off contracting back in. Proposals on how the future contracting-out regime could be structured were the subject of a consultation exercise which ended on 14 January 2000. After giving careful consideration to all the responses, the Government has decided to introduce measures which provide for:

- all rebates for contracting-out into a personal pension, including a personal pension based stakeholder pension, to be calculated to reflect the enhanced 3 part accrual rate in the State Second Pension;
- rebates to continue to be calculated as they are now for all occupational pension schemes, which will not be required to change their benefits;

- people in all contracted-out pension arrangements on low earnings (up to £9,500) to get a top-up from the State Second Pension; and
- the top-up to be extended to people on moderate earnings (up to £21,600) in contracted-out occupational pension schemes.

354. The combination of these measures will ensure that low and moderate earners in contracted-out provision will also benefit from the extra help that the State Second Pension will give. This will simplify the choice of alternative pension vehicles available to them, without their having to contract back in to the state scheme to access that help.

355. These proposals will also apply when State Second Pension becomes a flat-rate scheme for those who are contracted-in to the State scheme. Rebates and any state scheme top-up will continue to be earnings-related. This will prevent disruption to schemes at that stage, as well as providing an incentive for moderate earners to contract-out of the state scheme into a funded arrangement and ensuring that they will continue to be better off under State Second Pension.

Contracted-out Personal Pension Schemes

356. The rebate for contracted-out personal pension schemes will be based on the different accruals within the State Second Pension. For example, as the accrual rate for those earning at or above the annual Lower Earnings Limit but below £9,500 will double in relation to SERPS, so will the rebate. Low earners will therefore get a rebate based on a 40% rather than a 20% accrual which will be paid directly into their pension fund. For moderate earners it will be based on 40% on the first band of earnings, up to £9,500, and 10% on the second band, up to £21,600.

357. However, unlike State Second Pension, which will treat those earning at or above the annual Lower Earnings Limit but below £9,500 as if they were earning that amount, the rebate for low earners will remain based on actual earnings. To ensure that they still get the extra help from the low earner's boost, they will get a State Second Pension "top-up". In broad terms, the top-up will operate by calculating the State Second Pension an individual would have received had he not contracted-out (which of course includes the low earner's boost) and taking away an amount which represents the pension derived from the rebate.

358. This means that someone earning £8,000 would receive benefits from their pension scheme based on their actual earnings of £8,000 and a State scheme top-up based on £1,500 (the difference between actual earnings and £9,500). The rebate would be based on 40% of actual earnings between the Lower Earnings Limit and £8,000, and the top-up would be based on applying the 40% accrual to the £1,500.

Contracted-out Occupational Schemes

359. The system will operate slightly differently for occupational schemes in order to cater for the Pensions Industry's desire to avoid disruption to employers. Occupational schemes will therefore continue to have their reduced rate of National Insurance contributions calculated on the same basis as now – that is, a uniform accrual rate of 20%.

360. In order to ensure that individuals in these schemes receive the extra help intended for low and moderate earners, an extended State Second Pension "top-up" will apply. It will work on the basis of calculating the State Second Pension that an individual would have received if he had not contracted-out, less a deduction equating to a pension derived from the rebate input (ie 20% of actual earnings).

361. This means that for people in occupational schemes, all the extra help is delivered by way of the State scheme, rather then partly through their scheme via the rebate, and partly through the state, as is proposed for personal pension schemes.

Reporting on the effect on the NI Fund of earnings uprating.

362. This Act requires the Secretary of State to lay before Parliament a Government Actuary report which will estimate the effect on the balance in the National Insurance Fund, and the rate of National Insurance contributions needed to keep the Fund in balance, if the basic state pension were to be increased in line with earnings. The report will project figures for each year up to and including 2005/06.

Protection of "inherited SERPS"

363. As a result of changes originally enacted in the 1986 Social Security Act, the amount of additional pension a surviving spouse could expect to inherit was due to be halved in respect of a married person who died after 5 April 2000. The Welfare Reform and Pensions Act 1999 included provision to make regulations that would provide for, among other things, the deferral of the start of the new rule to a later year, and the setting up of a scheme to determine who may suffer future financial loss as the result of incorrect information about the impending change.

364. This Act provides for the new rules to apply from October 2002 (but also provides that this date may be further postponed by regulations) and clarifies the eligibility criteria for the Inherited SERPS scheme.

Improving pensions information

365. The Act also contains a measure to improve overall pension information for individuals so that they have a clear indication of what sort of retirement income to expect and can therefore make better-informed decisions on what savings they need to make. This will:

- permit state pension information to be passed to employers and pension providers so that they can issue pension statements giving details of both state and private pension rights unless individuals have indicated that they do not want the information. Because employers and pension providers will not need to gain the express consent of individuals the measure will improve the take-up of combined pension statements by employees and reduce administrative burdens; and

- provide that state pension details can be passed to other third parties such as organisations which provide financial information services so that individuals who give consent can access their state pension details through these services.

Improving the framework for occupational and personal pensions

366. Besides the reform of the National Insurance rebate, there are four main parts to the reform of occupational pensions in the Act:

- increased member involvement in schemes by requiring that all schemes must have one-third Member-Nominated Trustees (MNTs) by a process laid out in regulations or under procedures devised by the employer and approved by scheme members. The purpose is to increase confidence in the schemes, thereby encouraging more employees to join;

- further protection of members' pension rights by:

  — allowing the Occupational Pensions Regulatory Authority* (Opra) to make their register of disqualified trustees more accessible to the public; and

  — giving powers to Opra to monitor schemes which are in the process of winding up to ensure that winding up is undertaken as quickly as possible;

- changes to the existing regulation-making powers to enable future regulations to require money purchase schemes to provide members with an illustration of the likely future value of their pension, thereby improving members' appreciation of the value of their pension rights; and

- measures to provide further clarification, simplification and flexibility for those operating schemes. These will:
  - — increase the options for discharging contracted-out pension rights;
  - — increase the options available to scheme members when they transfer their pension rights; and
  - — allow a greater range of persons to make representations to the Pensions Ombudsman.