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17 October 2018

Ref: FOI2018/15973

Dear C Thompson

Freedom of Information Act 2000: Consolidating of contracted out deductions

Thank you for your enquiry of 20 September 2018, which we have considered under the terms of the Freedom of Information Act 2000 (the FOI Act).

You asked for the following information:

> *"Can you please tell me if you have been in correspondence with the DWP regarding consolidating of Contracted out Deductions for each year post State pension Age as mentioned on page 25 of Pensions bill 2011 MPs' information pack and if so let me have copies of the correspondence.*
>
> *Please see relevant wording shown below.*
>
> *further calculation will then be made to establish the value of this Contracted-Out Deduction for each year post State Pension age using the average number of years a pension is in payment*
>
> *Pensions Bill 2011*
> *MPs' information pack*
> *To be read in conjunction with the Pensions Bill, as read for a first time in the House of Commons on 27 April 2011, and accompanying Explanatory Notes*
> *Version One*
> *19 May 2011*
>
> *Department for Work and Pensions*
>
> *Page 25*
>
> *A further calculation will then be made to establish the value of this Contracted-Out Deduction for each year post State Pension age using the average number of years a pension is in payment. This calculation will take*
> *21 Net Additional Pension cannot drop below zero, even if somebody's Contracted-Out Deduction is larger than gross Additional Pension. There is no mechanism to impact basic State Pension rights in this instance. This means people can sometimes "win" from contracting-out.*
>
> *Pensions Bill 2011 – MPs' information pack*

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account of the fact that the Contracted-Out Deduction is not uprated in respect of pre 1988 accruals and capped at three per cent for post 1988 accruals.
• The value of the total Contracted-Out Deduction made over the average number of years a pension is in payment will be established.
• This value will then be used to produce a weekly Contracted-Out Deduction that is revalued and increased in the same way as the AP. It is this weekly rate that will be the deduction from the gross AP accrued between 1978 and 1997 at the time of consolidation.
19. This calculation requires making certain assumptions about the future which will be made by GAD, with consultation, ensuring that the most up to date information on life expectancy, earnings and prices growth is used. Where these assumptions are not borne out in practice individuals would get less or more AP, depending on whether the assumptions were set at too high or too low a level."

Following a search of our records, I can confirm that HM Treasury does hold information within the scope of your request. Attached is information related to consolidating of contracted out deductions, which explains DWP's business changes resulting from the simplification of second tier pensions as defined in the Pensions Bill 2007. Any text that is not relevant to your request and therefore out of scope has been redacted.

You might find it helpful to know that due to the Pensions Act 2014, which introduced the new State Pension in April 2016, consolidation of contracted out deductions was not implemented.

If you have any queries about this letter, please contact us. Please quote the reference number above in any future communications.

Yours sincerely

Information Rights Unit

Enclosure: Copy of information relating to consolidation of contracted out deductions in the Pensions Reform Delivery Programme document from DWP

Copyright notice

Your right to complain under the Freedom of Information Act 2000

If you are not happy with this reply, you can request a review by writing to HM Treasury, Information Rights Unit, 1 Horse Guards Road, London SW1A 2HQ or by emailing us at the address below. Any review request must be made within 2 months of the date of this letter.

Email: foirequests@hmtreasury.gov.uk

It would assist our review if you set out which aspects of the reply concern you and why you are dissatisfied.

If you are not content with the outcome of the review, you may apply directly to the Information Commissioner for a decision. Generally, the Commissioner will not make a decision unless you have exhausted the complaints procedure provided by HM Treasury which is outlined above.

The Information Commissioner can be contacted at: The Information Commissioner's Office, Wycliffe House, Water Lane, Wilmslow, Cheshire SK9 5AF (or via their website at: https://ico.org.uk).

Annex A - FOI2018/15973
Copy of information relating to consolidation of contracted out deductions in the Pensions Reform Delivery Programme document from DWP

[Information not relevant]

Arrangements for people who have been contracted out of the state scheme will be simplified. The contracted-out deduction (CoD) will still be applied where appropriate but the CoD amount will be flattened out using actuarial equivalence (see paragraph 3.6.3).

[Information not relevant]

Consolidation arrangements for those who have been contracted out

For this consolidation to work effectively there needs to be a parallel change in the arrangements for taking account of contracting-out in the state system. This is a key issue as around a third of pension accounts have some contracted-out rights. The arrangements from 1978 to 1997 are very complex as a CoD is made from the AP to reflect the individual's entitlement to a contracted-out pension. The amount of the CoD is equal to the GMP or notional GMP earned during periods of contracting out between 6 April 1978 and 5 April 1997 excluding any GMP increments. In brief:

- The AP calculation revalues past earnings by average earnings over the working life. The GMP (and the CoD) can be revalued by other factors – leaving it difficult to accurately predict net AP at SPa.

- AP is increased by prices once in payment while pre-1988 GMPs are not indexed at all and post-88 GMPs are only partially increased. There will be some cases where there is no AP to be paid at SPa but, where AP surpluses arise in later years because the price uprated AP overtakes the GMP (and the CoD) which is rising more slowly, AP will become payable.

For consolidation to work the CoD needs to be "fixed" in relation to the AP. The result would be a fixed deduction with any AP also being paid as a fixed sum (subject to normal uprating) with the adjustment being made in 2012 rather than at SPa.

To overcome this problem the CoD will be flattened out through actuarial equivalence. This is a system used extensively in pensions to change the shape of a pension while maintaining its value. The assumptions and methodology will be determined following a report by the Government Actuary's Department (GAD), but put very simply, the process is that:

- Contracted-out information for each individual is held on the National Insurance Recording System (NIRS). The amount of GMP that the contributor would have received at SPa will be calculated using the appropriate revaluation rate (including Section 148 orders where appropriate).

- A further calculation will then be made to establish how much this GMP would be year on year using the average number of years a pension is in payment. This calculation will take account of the fact that the GMP may not be fully uprated by the Retail Price Index (RPI).

- The sum of this calculation will then be smoothed out over a typical lifetime to produce a weekly rate. It is this weekly rate that will be the CoD adjustment to gross AP at the time of consolidation. This calculation will produce a net amount of AP which will be revalued by earnings to SPa. The net amount, together with basic SP, will provide an accurate rate of pension that the contributor will see at SPa and through retirement.

GAD will provide the conversion calculations to arrive at the 2012 value of the GMP which will be used to determine the CoD to be applied. The calculations will not be prepared until 2011/12 to ensure that the latest information on life expectancy and forecasts of earnings and inflation growth are used. The calculations will be legally binding and, regardless in what year a conversion calculation is carried out, the same life expectancy and other factors will be used in the calculation.

The outcomes customers will receive after simplification of the GMP (and the CoD) will be different to what they would receive if the current system rolled forward and some people will gain AP and some people will lose.

The reason why customers will gain or lose is that the smoothed weekly amount of the CoD is calculated using average life expectancy. Under existing arrangements a typical pattern of entitlement after SPa would see the gross AP being uprated at a higher amount than the GMP (and therefore the CoD). Year on year customers would see a growing amount of AP. The intervention proposed would see the customer receiving the same amount at retirement and through retirement, subject to annual uprating by prices.

Compared to average life expectancy, if a customer dies earlier than average, they would receive more AP than they would be entitled to under the current arrangements. If they live longer than average, they would receive less AP than under current arrangements.

Widows, widowers and surviving civil partners

Widows, widowers and surviving civil partners can inherit part of their spouse's or civil partner's AP on bereavement. The structure of "inherited SERPS" is going through a transition at the moment, but by 2020 surviving spouses and civil partners will generally be entitled to half of their spouse's or civil partner's AP on bereavement. This position will remain unchanged as a result of consolidation. The surviving spouse or civil partner will generally receive half of the 2012 AP valuation.

If the deceased had been contracted out, the inherited SERPS would also be subject to a CoD. The current position for widows is that the amount of AP that can be inherited is generally reduced by 50% of the late husband's GMP (and therefore the CoD).

A widower or surviving civil partner inherits SERPS in exactly the same way as a widow. However, for this group only GMPs accrued post-1988 are used to provide for the survivor benefit. A survivor is generally entitled to half of their spouse's or civil partner's accrued GMP, hence only a 50% CoD is applied.

Due to the complexity of the existing arrangements for inheritance of AP and the CoD, the consolidation calculation might not be applied when working out the inherited AP entitlement of certain bereaved people. The groups affected will be specified in regulations.

[Information not relevant]

An increase paid by the State on account of the inflation-proofing of GMP increments is referred to as payable up-rated contracted-out deduction increments (PUCODIs).

As the information on pre-1997 and post-1997 accruals is held by NIRS2 and could be accessed by the Department for Work and Pensions (DWP), the continuation of PUCODIs is not affected by consolidation.
[DN: The working assumption is that PUCODIs will be abolished and GMP increments will no longer affect SP entitlement. Should this not be the case we have yet to bottom out how PUCODIs will work after consolidation. Ministerial agremeent for this has yet to be secured.]

[Information not relevant]

The table below specifies the high level functional business requirements for State Pensions Reform. For each uniquely numbered requirement, the impact has been assessed against the main work areas. A tick in the relevant column will show that a requirement impacts on a particular area. If no impact, a cross is shown in the relevant column.

BR No.	Requirement description	Traini	Guida	Notifi	Forms	Interf	Priorit	Comments
[Information not relevant]								
BR 106 /07	The CoD will be flattened through actuarial equivalence. The assumptions and methodology will be determined by GAD.	▯	▯	▯	▯	▯	M	
BR 106 /08	The actuarial equivalence process will apply as follows: • Calculate what GMP a contributor would receive at SPa and then apply GAD factors to arrive at what figure	▯	▯	▯	▯	▯	M	

BR No.	Requirement description	Traini	Guida	Notifi	Forms	Interf	Priorit	Comments
	they would receive for the rest of their life. • Total amount up and divide it by the number of weeks the pension is expected to last to arrive at a smoothed weekly CoD. • Apply the CoD to the gross AP that the contributor has accrued until 2012. The net amounts are revalued by earnings and the net figure will be the amount shown in pension forecasts as the amount payable at SPa alongside any post-2012 accruals.							
BR 106 /09	The factors used to revalue CoD will remain the same regardless of the date that consolidation actually takes place.	▯	▯	▯	▯	▯	M	The working assumption is that GAD would consult in 2010/11 alongside their rebate review to agree factors for earnings growth, inflation growth and longevity that would be used to revalue the CoD.
[Information not relevant]								

[Information not relevant]

No	Issues
[Information not relevant]	
IS05	In the event that Payable Uprated Contracted Out Deduction Increments (PUCODI) are not abolished, need to determine how they will work after the consolidation of GRB and AP.

[Information not relevant]

Contracted out Deductions

Contracting-out is taken into account by reducing the gross AP. However this reduction is achieved in different ways, depending on the period in question.

Graduated Retirement Benefit 1961 to 1975

From 1961 to 1966, an individual who was contracted out has no entitlement to any GRB covering the period of the contracting out. Instead he built up an entitlement in the private pension to what was known as Equivalent Pension Benefits. From October 1966 those who were contracted-out paid a lower level of contribution and began from that date to build up some entitlement to GRB, albeit at a slower rate than someone who was contracted-in.

State Earnings Related Pension Scheme: 1978 to 1997

From 6 April 1978 to 5 April 1997, one of the requirements of contracting-out for Contracted Out Salary Related (COSR) schemes was that scheme provided a pension at least equal to a guaranteed minimum amount. The objective of the guaranteed minimum was that schemes had to provide an amount of pension at state pension age which was broadly equivalent to the AP to which the member would have been entitled to at state pension age had they not contracted-out. The GMP is not identical to AP, for example AP contains different protection in terms of inflation-proofing, protection of rights of early leavers and survivor's benefits.

Other than in Defined Contribution (DC) schemes (see below) the individual built up an entitlement in the contracted out private pension scheme to a GMP which is broadly, but not exactly, calculated in the same way as SERPS. All the GMPs which the individual has built up during this period are added together and deducted from the gross SERPS (the CoD). If a person's GMP is greater than their AP then their AP is effectively reduced to zero. Changes in the amount of GMP after the benefit including AP becomes payable (such as the annual indexation increase) will result in changes to the amount of the contracted-out deduction.

If a member leaves the pension scheme before retirement age, but leaves his accrued benefit behind, the GMP is revalued. The scheme was permitted to choose from three different methods of revaluation and only one of these is the same as that used in SERPS. This means that the amount of the CoD as a proportion of the gross SERPS will vary from year to year. Some of the GMP revaluation rates adopted have turned out to be much greater than the rate used for SERPS and therefore the GMP can be significantly higher than the gross SERPS at SPa.

Once SP is in payment, the CoD calculation is re-done every year. SERPS is fully indexed in payment, but GMPs are only partially indexed by the scheme. Thus the balance between the two amounts can change each year when in payment. Crucially, some people can have a nil entitlement to pre-1997 SERPS at SPa because the CoD is higher, but come back into entitlement in a subsequent year, as the difference is eroded by the higher indexation of SERPS.

Defined Contribution Arrangements

The description above is based on Defined Benefit (DB) scheme arrangements. However, a similar system applies to DC schemes. A notional GMP is calculated which is revalued up to SPa in the same way as SERPS. This notional GMP is deducted from the SERPS. It is also indexed after SPa in the same way as DB GMPs.

State Earnings Related Pension Scheme: 1997 - 2002

The CoD system ended in April 1997, when GMPs ceased to accrue for post 1997 periods. From 6 April 1997 a salary-related scheme could contract out if it gave its members the right to accrue benefits at least as valuable as the benefits set out in the "reference scheme test" (as defined in the legislation). The system of contracted-out deductions does not apply. This meant that a person is treated as having no earnings for the purposes of calculating SERPS for every week they are contracted-out (whether in a DB or DC system).

The reference scheme test includes requirements that the scheme pension be payable at no later than 65, have an accrual rate of at least 1/80th and that spouse's pensions of at least 50% of the member's pension be provided. At least 90% of the schemes active members (ie those currently in contracted-out employment) and their widows or widowers must be entitled to pensions that meet the reference scheme test or are at least as valuable as the benefits under the reference scheme test.

State Second Pension: 2002 -

Since April 2002 a member of such a scheme may accrue some Additional Pension but this is not calculated by reference to the amount of scheme benefits received. For S2P the rebate is taken into account by deducting a specific amount from the gross S2P. This specific amount is calculated in the same way as SERPS was.

Survivor Inheritance: Widows, widowers and civil partners

Defined Benefit Schemes

A survivor (ie. widow, widower and surviving civil partner) of a person who was contracted-out inherits half the individual's DB benefit that accrued from April 1997. The inherited AP is also reduced by half.

However, the rules governing inheritance of contracted-out DB benefits pre-1997 are more complicated. A widow can inherit half her late husband's GMP if she fulfils certain conditions, based on age and/or receipt of other qualifying benefits. A widower and a surviving civil partner inherit only half the GMP based on post-1988 accruals. This difference is reflected in the CoD.

Defined Contribution Schemes

There is a slight difference for DC schemes. A person who is married, or who has a civil partner when they annuitise their protected rights must buy a double life annuity, giving the survivor a half pension. Where the individual subsequently dies, half the notional GMP is deducted from the survivors' inherited SERPS.

However, where a member of a DC arrangement dies before annuitising his protected rights, his survivor inherits his full fund. In these circumstances the CoD is not half, but the full amount.

D.N. With the removal of the rules on "protected rights" from 2012 this position may change at a later date.