Pensions Policy Institute

PPI

The Pensions Primer: A guide to the UK pensions system

Updated as at June 2015

The Pensions Primer: a guide to the UK pensions system

A reference manual by the Pensions Policy Institute

This version of *a guide to the UK pensions system* reflects the current position of, and legislated future changes to, the UK pension system as at June 2015. Any change in Government policy that may have occurred after that date is not included in this version.

Published by the Pensions Policy Institute

www.pensionspolicyinstitute.org.uk

An introduction to the UK pension system

The foundations of the UK pension system were laid in the 1940s. Since the 1960s, successive governments have made many changes to both state and private pensions resulting in today's pension system, which is complex and multi-layered.

This document is intended to provide a description of the UK pensions system for the purposes of considering pensions policy. It should not be used to make individual pension decisions.

This guide primarily reflects the current position of the UK pension system as at 24 June 2015. Any changes in Government policy that may have occurred after that day have not been included in this version. The Pensions Act 2014, which received Royal Assent in May 2014, will have a major impact on the future pension system in the UK as it includes far-reaching changes, such as the introduction of a New State Pension. This paper sets out these changes in boxes.

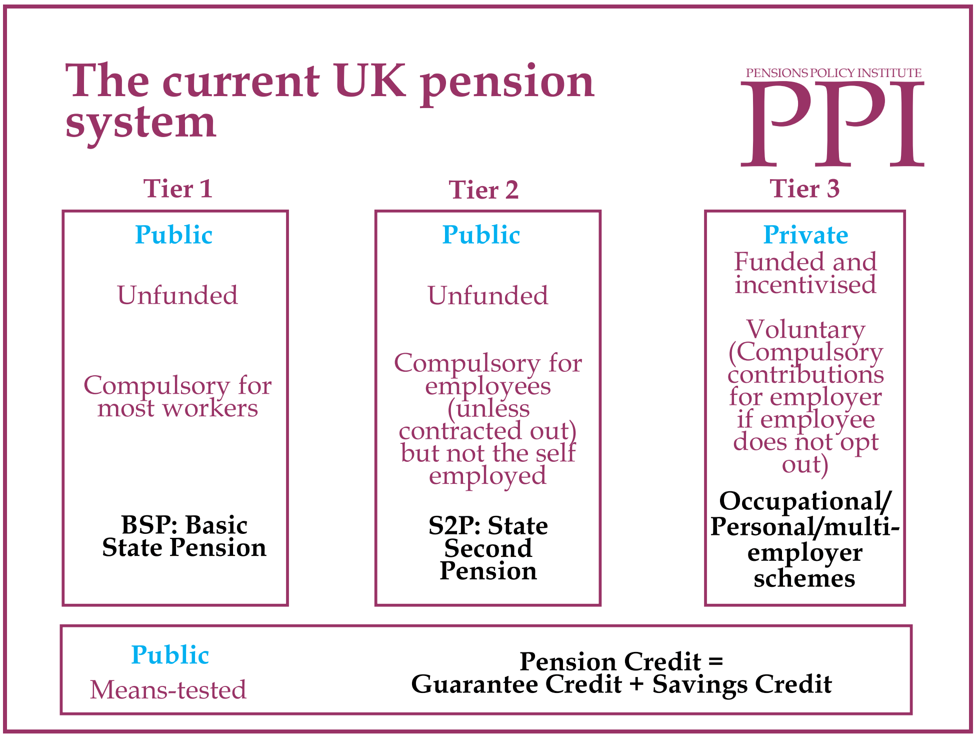
This guide uses a box format to explain changes that have been legislated for in Acts of Parliament but are not yet applicable. Boxes are also used for areas in which the Coalition Government has announced a change in policy that has yet to be enacted by Parliament, or areas in which it is consulting on future policy changes.

To explain the UK pensions system, this report uses a multi-tier framework. The UK pensions system can be considered to possess three tiers:

- **Tier 1** is provided by the state and consists of a basic level of pension provision to which everyone either contributes or has access, providing a minimum level of retirement income.
- **Tier 2** is also provided by the state and aims to provide further pension income that is more closely related to employees' earnings levels. Tier 2 is less redistributive (from rich to poor) than Tier 1. Tier 1 and Tier 2 operate on an unfunded 'pay-as-you-go' contributory basis, through the National Insurance (NI) system.
- **Tier 3** is private pension provision, namely all those voluntary pension arrangements that are not directly funded by the state. Private pension contributions, from the employer and/or the individual, fund designated pensions for the individual. The primary aim of private pensions is to redistribute income across an individual's lifetime, and not to redistribute income from higher-income to lower-income people. Tier 3 includes pensions arising from automatic enrolment, a policy requiring employers to enrol eligible employees into a qualifying workplace pension scheme.

Chart 1 illustrates the three tier UK pensions system as it stands today. Although means-tested benefits span across the three tiers, they are covered in the *First tier provision* section of *a guide to the UK pensions system*.

Chart 1



The next section of this guide describes each of the tiers of the UK pension system. Subsequent Reference Notes (RN) provide details on many of the points covered.

First tier provision

The first tier of pension provision is provided by the state and consists of a basic level of pension provision to which everyone either contributes or has access, providing a minimum level of retirement income. Included are:

- The Basic State Pension
- Pension Credit

The first tier operates on a 'pay-as-you-go' basis, through National Insurance (NI) and general taxation. NI contributions levied on workers' earnings are used to pay the Basic State Pension. Pension Credit is funded through general taxation.

Pensioners receive other benefits, mainly funded through general taxation that could be considered as part of the first tier provision, these include (but are not limited to):

- Housing Benefit
- Council Tax Reduction
- Other (near) universal benefits

The **Basic State Pension** (BSP) is a contributory pension in the sense that the final amount of BSP paid to an individual depends on the number of National Insurance contributions made before reaching State Pension Age (SPA).

SPA depends on an individual's birth date. It is currently 65 years of age for men. Women's SPA is currently around 62½ and is rising to equalise with men's at age 65 by November 2018 (Pensions Act 2011). Men and women's SPA will increase to 66 between December 2018 and October 2020 (Pensions Act 2011).[1]

Under previous legislation, SPA was scheduled to increase to age 67 between 2034 and 2036 and to age 68 between 2044 and 2046. However, the Government has brought forward the rise to age 67 to now take place between 2026 and 2028.[2] This change was included in the Pension Act 2014. The Government has also announced an intention to review the timescale for the rise to age 68.[3]

The Pensions Act 2014 sets out the Government's plans for the SPA in the future.[4] This includes an SPA review every 5 years based on analysis provided by the Government Actuary's Department and an

[1] www.gov.uk/government/uploads/system/uploads/attachment_data/file/310231/spa-timetable.pdf
[2] Announced in the Chancellor's Autumn Statement, 2013: www.gov.uk/government/topical-events/autumn-statement-2013
[3] www.gov.uk/government/policies/reviewing-the-state-pension-age
[4] *Pensions Act 2014* www.legislation.gov.uk/ukpga/2014/19/contents/enacted

independently-led body, with the underlying principle that people should expect to spend a certain proportion of their adult life in retirement. For this purpose, adult life is defined as starting at age 20.[5]

Introduction of the New State Pension
The Pensions Act 2014 made provisions for the introduction of the New State Pension, which will replace the current Basic State and additional state pensions. The New State Pension will be set at a level above the Guarantee Credit element of Pension Credit, which is currently £151.20 a week for a single pensioner (2015/16). Previous state pension entitlements will be recognised under the New State Pension system.

The New State Pension will only be available to pensioners retiring after the date of implementation which was initially planned to be 2017 at the earliest; however, the Chancellor announced in Budget 2013 that the New State Pension take place from 2016.[6]

There are differences between the qualification requirements under the New State Pension and the current system: for example, under the New State Pension system, 35 years of National Insurance Contributions or credits will be required for an individual to receive a full rate of pension, compared to 30 years under the current system; under the New State Pension system people will need a minimum of 10 qualifying years of contributions or credits to qualify for any state pension, while under the current system there is no minimum.

The transition process will involve translating people's pre-implementation National Insurance records into a starting amount, known as the 'Foundation amount' – those people with a foundation amount that is less than the full level of the New State Pension will be eligible to receive the full level of the New State Pension, if they have contributed for sufficient years; people whose state pension entitlement under the old system is greater than their entitlement would be under the New State Pension will still receive their full entitlement under the New State Pension system.

The National Insurance contribution rules for BSP are complex, and there are a number of ways in which contributions can be made or credited. There are further rules for married couples, people with incomplete contribution records, and older pensioners. For people retiring between 6 April 2010 and 5 April 2016, 30 years of National Insurance contributions or credits is considered to be a full contribution record, and a proportionate amount of pension is paid to those people who have fewer than 30 years of National Insurance contributions or credits.

[5] DWP (2013) *The core principle underpinning future State Pension age rises: DWP background note*
[6] HMT (2013) *Budget 2013*, p. 5. www.hm-treasury.gov.uk/budget2013_documents.htm

BSP is a redistributive, flat rate pension payable once an individual reaches State Pension Age. Subject to having made the same number of contributions, individuals will receive the same level of benefit, irrespective of the size of the contributions. A single pensioner with a complete National Insurance contribution record is eligible at their SPA to receive a full BSP of £115.95 a week (2015/2016).[7]

BSP receipt can be deferred until after SPA in return for either an increase in the level of state pension payments or a lump sum. Those who defer claiming their state pension for less than twelve months are only eligible to receive an enhanced state pension. Those who defer claiming their state pension for at least twelve months can choose to receive an enhanced state pension or a taxable lump sum and a non-enhanced state pension.[8]

Between 1974 and 1979, BSP was increased annually by the greater of the increase in National Average Earnings (NAE) or the increase in the Retail Prices Index (RPI). Since 1979, annual increases have generally been linked to RPI.[9] The net effect of past uprating has been that, although the value of the full BSP has increased in price terms since the 1970s, it has reduced relatively to average earnings from 24% of NAE in 1974 to an estimated 16% of NAE in 2009.[10]

From April 2011 the BSP has been uprated by the higher of the increase in earnings, the Consumer Prices Index (CPI) or 2.5%. The Government has named this mechanism the “triple lock”.[11] However, legislation only provides that the increase in the basic state pension must be at least at the rate of the increase in average earnings, therefore the BSP or New State Pension may be re-indexed at some point in the future, unless the triple-lock becomes enshrined in legislation.

In addition to the Basic State Pension, there are a number of means-tested benefits that pensioners may be eligible for depending on their circumstances.

Pension Credit (PC) has two components: Guarantee Credit (GC), currently payable from age 62½, and Savings Credit (SC), payable from age 65. From 2010, the minimum age for receiving GC is increasing in line

[7]www.gov.uk/government/uploads/system/uploads/attachment_data/file/382867/proposed_benefit_and_pension_rates_2015_to_2016.pdf
[8] *Deferring your State Pension: leaflet* www.direct.gov.uk/prod_consum_dg/groups/dg_digitalassets/@dg/@en/@over50/documents/digitalasset/dg_200597.pdf
[9] Since 2004 BSP has been increased by the higher of 2.5% or the RPI
[10] PPI estimate; Department for Work and Pensions (DWP) (2009) Abstract of Statistics 2008 Section 5 - Rates of Benefit research.dwp.gov.uk/asd/asd1/abstract/abstract2011.pdf and Office for National Statistics (ONS) (2009) Annual Survey of Hours and Earnings 2009 www.ons.gov.uk/ons/rel/ashe/annual-survey-of-hours-and-earnings/2009-revised/index.html
[11] webarchive.nationalarchives.gov.uk/20130129110402; www.hm-treasury.gov.uk/fin_consumer_finprovision.htm

with increases in women's SPA, (as introduced by the Pensions Act 1995).[12]

Guarantee Credit is the main means-tested benefit currently paid to those aged 62½ and above. People (or households) become eligible for GC if other means (sources of income) do not reach a certain level. If claimed, GC provides a safety net of a minimum level of income. GC is paid on a 'benefit unit' basis; meaning that it is paid to a single person or a couple, on the conditions that income from other sources is below the level of full GC, and provided any hours worked and savings held are below specified limits.

GC is redistributive. It is paid for from current taxes, which increase with an individual's income, while GC payments are only made to those on low incomes.

Currently, GC provides a minimum income of £151.20 a week for single people and £230.85 a week for couples. GC entitlement can be higher for disabled people, people with caring responsibilities or people with a mortgage.

The Pensions Act 2007 requires the GC to be increased by a percentage at least equal to the increase in national average earnings. For 2015/16 the Government increased the GC by a higher percentage than the rise in national average earnings because prices rose more quickly than earnings over the previous year; resulting in a rise in the benefit that is in line with the cash rise in the Basic State Pension.[13]

Savings Credit aims to ensure that those who have made some private provision for retirement, or have made provision in excess of the Basic State Pension, including SERPS and S2P, will be better off than those who have made no provision.

The maximum amount payable under Savings Credit is £14.82 a week for a single person and £17.43 a week for a couple from April 2015. For every £1 of income received[14] above the level of the Savings Credit threshold (£126.50 for single pensioners and £201.80 for couples, in 2015/16), but below the level of Guarantee Credit, Savings Credit pays an additional benefit of 60p. The credit is then 'tapered down' for additional income above the Guarantee Credit level.

[12] The State Pension Credit Act 2002 sets the qualifying age for the Guarantee Credit to be the same as the State Pension Age for women.
[13] House of Commons (2012) "2015 Benefit uprating", www.parliament.uk/business/publications/research/briefing-papers/SN07054/2015-benefit-uprating
[14] From ongoing employment, SERPS, Graduated Retirement Benefit, occupational schemes, personal pensions and assumed income from capital savings

Housing Benefit and Council Tax Reduction are means-tested benefits available to both pensioners and people under State Pension Age. Although they are not part of the first tier of pension provision in the UK, they are included here because they are nevertheless important benefits for many older people.

Housing Benefit (HB) is paid to people on low incomes who rent their home. It is designed to help with housing costs, including rent and some accommodation-related service charges. It is paid to renters who claim the benefit once they have been assessed as being eligible.

Not everybody that is eligible claims Housing Benefit. Official estimates show that, in 2009/10, between 16% and 22% of the between 1.7 and 1.9m pensioner households who were eligible did not take up their benefit.[15]

Council Tax Reduction (CTR) is a rebate scheme to provide help with up to 100% of an individual's council tax. Local councils design their own scheme.[16]

According to official estimates, take-up of Council Tax Benefit (the precursor to Council Tax Reduction) was relatively low; in 2009/10 between 31% and 38% of pensioner households who were eligible did not take up their benefit.[17]

Pensioners receive other, non-pension benefits that could be considered as part of the first tier of provision:

- Benefits individually assessed for specific purposes (for example, Attendance Allowance)
- (Near) Universal benefits for all or most people at a certain age (for example, free TV licenses, Winter Fuel Payments)
- Enhanced tax allowances compared to working-age people (however, age-related tax allowances are being phased out from April 2013). Those born after 6 April 1948 are not eligible for an age-related higher personal tax allowance.[18]

[15] Department for Work and Pensions (DWP) (2012) *Income Related Benefits Estimates of Take-up in 2009-10,* www.gov.uk/government/organisations/department-for-work-pensions/series/income-related-benefits-estimates-of-take-up--2
[16] www.gov.uk/government/uploads/system/uploads/attachment_data/file/14787/LCTS_Q_A.pdf
[17] Department for Work and Pensions (DWP) (2012) *Income Related Benefits Estimates of Take-up in 2009-10,* www.gov.uk/government/organisations/department-for-work-pensions/series/income-related-benefits-estimates-of-take-up--2
[18] Chancellor of the Exchequer's Budget, March 2012, www.gov.uk/tax-national-insurance-after-state-pension-age/agerelated-tax-allowances

Second tier provision

Introduction of the New State Pension
Once the New State Pension has been introduced in 2016, people will not be able to accrue further entitlement to the additional state pension or contract out of paying a portion of their National Insurance contributions. Those with entitlement to the additional state pension accrued before the introduction of the New State Pension will still be able to claim their entitlement when they reach State Pension Age.

The UK's second tier of state pension provision operates on an unfunded 'pay-as-you-go' contributory basis, through the National Insurance (NI) system. Benefits are payable from State Pension Age (SPA), but can be deferred. The self-employed are currently excluded from second tier provision.

The original aim of the second tier was to provide further pension income to employees more closely related to their earnings level than the flat rate that people receive from the first tier. Contributions are made in proportion to earnings (in a band between minimum and maximum limits). Benefits reflect these contributions, resulting in less redistribution (from rich to poor) than in the first tier.

Second tier provision in the UK has existed in three different guises:
- Graduated Retirement Benefit (GRB: 1961 to 1975)
- State Earnings Related Pension Scheme (SERPS: 1978 to 2002)
- State Second Pension (S2P: from April 2002)

Between 1975 and 1978 there was no accrual of additional state pension entitlement. Some of today's pensioners still receive small amounts of benefit from accrued rights to the **Graduated Retirement Benefit (GRB).**

The **State Earnings-Related Pension Scheme (SERPS)** is more significant for current pensioners. The original aim of SERPS was to provide a pension of 25% of band earnings. Subsequent changes to SERPS have reduced its value.

State Second Pension (S2P) started in 2002 as a replacement for SERPS. The main aim of S2P is to target greater resources at the lower paid and some individuals who cannot work due to disability or caring responsibilities. It is therefore more redistributive than SERPS, and people working on low pay benefit more than they did under SERPS.

The pattern of accruing benefits under S2P is currently based on two earnings bands and two accrual rates.[19] For low earners, a flat rate of S2P pension is accrued. Higher earners accrue an additional earnings-related benefit alongside the flat rate accrual. Disabled people, and some individuals with caring responsibilities, are credited into the flat rate part of S2P.

It is currently possible for members of Defined Benefit schemes to replace some state second tier provision with private pension provision. This is known as **contracting-out**.

Prior to April 2012, members of Defined Contribution pension schemes were able to contract out of S2P, however this option is now only available to members of Defined Benefit schemes.

Defined Benefit pension schemes can choose for their members to forego some S2P benefits from the state, provided that the scheme promises to pay benefits that are at least as valuable as the S2P benefits foregone. Individuals who contract out pay lower NI contributions, and so do their employers, since they are considered to be contributing the equivalent amount into the private pension scheme.[20] The reduction in the level of NI contributions is called the 'contracting-out' rebate.

The size of the rebate is set every 5 years with advice from the Government Actuary Department, and can act as an incentive or disincentive to contract-out depending on whether the return on the rebate is perceived to be of higher or lower value than the benefit payable under S2P.

[19] Earnings between the Lower Earnings Limit and the Upper Accrual Point. Before 6 April 2010, there were three bands accruing benefits at 40% 10% and 20%. Following provisions in the Pensions Act 2007, the former second and third bands have been merged into a single band accruing benefits at 10%. For more details, see page 43

[20] The exception to this is with money purchase or Defined Contribution schemes, where the level of NI contribution remains unchanged, but the Government later pays a rebate into the scheme

Third tier provision

The third tier of pension provision is **private pensions**, including workplace pensions and those that are not directly funded by the state. As with state provision, private pension provision is complicated.

Private pension contributions, from the employer and/or the individual, fund designated pensions for the individual. The primary aim of private pensions is to redistribute income across an individual's lifetime.

The majority of private pension arrangements are **employer-sponsored or workplace schemes**. The employer link may be very strong; for example, the employer can fund and administer an occupational pension scheme. The link may be loose; for example, the employer may only give access to a scheme run and administered by a pension provider. Many schemes are arranged through single employers, although multi-employer schemes are becoming increasingly popular in the private sector and there are a few industry-wide arrangements.

Individuals can make their own private pension arrangements by buying **personal pensions**. There are several types of these including master-trust pensions, stakeholder pensions and a distinct product called a personal pension. Each underlying product works on the money-purchase principle: that is, it takes money in through contributions, this money is invested in a fund, and the accumulated value is then available to be accessed at minimum pension age (currently age 55). Tax arrangements depend on the method of access and amount taken, though 25% of the fund may be taken as a tax-free lump sum or portion of withdrawals.

Individual contributions to private pension schemes obtain tax relief at least at an individual's highest marginal rate (within limits). The pension fund is accumulated in a tax-favoured environment. Any contributions an employer makes to private pensions are tax deductible and so reduce its corporation tax liability. The company also benefits from National Insurance relief.

A traditional form of workplace provision is provided through **occupational pension schemes**, which are set up and administered by or on behalf of an employer. Occupational pension schemes can be Defined Benefit (DB) or Defined Contribution (DC) or hybrid schemes, which have features of both DB, and DC schemes.

In **Defined Benefit** schemes the benefit received upon retirement is determined by a formula usually linked to a calculation based on time spent contributing and final or career average salary levels. Contributions are varied in order to ensure that the level of promised benefits are reached.

Defined Benefit schemes operate on a pooled fund basis; all contributions are paid into a common fund, which is invested to provide all retirement benefits. In the normal course of events the investment performance of the scheme assets has no or minimal impact on the benefits an individual receives. The better the investment performance the lower the contributions needed.

The benefit from DB schemes will usually be based on an individual's length of service and his or her earnings at, or close to, retirement. A scheme might typically promise a pension of $1/60^{th}$ of final salary for each year of service or a $1/80^{th}$ pension plus a tax-free lump-sum cash amount of $3/80^{ths}$ for each year of service.

Such schemes usually have a normal pension age of 60 or 65, but a member can generally retire early with a reduction in benefits. People leaving the scheme on changing employer can preserve their rights in the scheme until pension age, or transfer the accrued rights to another arrangement.

Because of the different nature of operation of DB and DC schemes, they carry different risks and benefits to the employer and employee, and there is much debate on the best arrangement for different types of employee.[21]

To increase the security of Defined Benefit occupational pension schemes, the government has introduced the Pension Protection Fund (PPF), which became operational in April 2005. The PPF pays a minimum level of pension to members whose original scheme becomes insolvent due to underfunding.[22]

Contracting-out of Second State Pension
Currently, DB schemes can contract-out of paying National Insurance contributions in respect of S2P. The Pensions Act 2007 abolished contracting-out in DC schemes from April 2012.

Defined Contribution occupational pension schemes operate under similar legislation to Defined Benefit scheme. The difference is that, while a DB scheme promises a specific level of benefit, a DC scheme operates on the money-purchase basis with a specified rate of contributions being paid into the scheme, but with no guarantee as to the level of the benefit that will be paid out.

[21] PPI Briefing Note Number 2 *The shift from Defined Benefit to Defined Contribution*
[22] Pension Protection Fund www.pensionprotectionfund.org.uk/ and HM Government (2004) Pensions Act 2004 www.legislation.gov.uk/ukpga/2004/35/pdfs/ukpga_20040035_en.pdf

Contributions are usually expressed as a percentage of salary or total earnings. The rate of contribution could be a flat rate or could be tiered by age and/or length of service and/or seniority and/or level of earnings. Employers may make a base level of contribution for all employees and may also match any employee's additional contribution.

Additional Voluntary Contributions
If only the employer contributes to the pension scheme, a scheme is known as non-contributory. Both employer and employee make contributions to contributory schemes. Until April 2006, all occupational pension schemes offered the facility for employees to make **additional voluntary contributions (AVCs),** either to accrue further benefits in the scheme or separately in free-standing arrangements. Some companies may no longer offer AVCs following changes to pension rules in April 2006, as there are now more options for people to top up their company pension through other means.[23]

Defined ambition, shared risk and collective benefit schemes
The Pension Schemes Act 2015 introduced legislation to facilitate the development of shared risk and collective benefit schemes in the UK. The Act defines three different categories of pension scheme based on the type of promise offered to members during the accumulation phase about the level or amount of pension benefits. This promise will either refer to all of the retirement income payable from the scheme (Defined Benefit), some of the retirement income or some or all of the pot (shared risk), or no promise (Defined Contribution). Some forms of risk-sharing schemes already existed for example, hybrid schemes (e.g., cash-balance schemes, or with-profit arrangements.

The Act also includes measures to enable the provision of collective benefits using **Collective Defined Contribution** (CDC) schemes. These schemes are enabled for in the Act through legislation allowing for scheme assets to be used in a way that pools risks across the scheme membership, by creating a single collective fund rather than individual funds (as in individual Defined Contribution.) The legislation allows for the development of new structures offering collective benefits that allow for the pooling of investment, inflation and longevity risks between members within a workplace pension structure, and allows for pensions in payment to fluctuate.

Personal Pensions
Employers can make arrangements for their employees without operating their own pension scheme. These usually involve giving access to group

[23] Between April 2001 and April 2006 members of an occupational pension scheme earning less than £30,000 per annum had an alternative 'concurrency' option. This allowed them to contribute up to £3,600 per annum into a stakeholder or personal pension. The £30,000 limit applied to each employment. So for example, it was possible for someone with more than one employment to have a concurrent pension even if his or her total earnings were above £30,000.

DC individual personal pensions or pensions provided by a master-trust or multi-employer scheme.

Until April 2001, individual personal pensions were only available to individuals while they were self-employed, or were not members of an occupational pension scheme. Legislation introducing stakeholder pensions widened access further, and from April 2006, individual pension arrangements became open to everyone under age 75.

Stakeholder pensions were introduced in 2001 as a form of DC personal pension that was required to meet a number of Government standards. The main difference between these and other types of personal pensions at the time was that the management charges in each year were limited by a maximum charge cap and providers were not permitted to charge exit penalties.[24] For people who joined a stakeholder pension after 6 April 2005, the maximum fund management charge was 1.5% for the first 10 years, thereafter reducing to 1%. For stakeholder plans that were opened before this date, the previous maximum charge of 1% continued to apply. However, subsequent legislation has removed most of the differences between stakeholder pension schemes and other pension schemes used for automatic enrolment.

Multi-employer pension schemes

Though employers are no longer required to provide access to Stakeholder schemes, as required under previous legislation, they are still available for use alongside other personal pensions. Automatic enrolment has also heralded the rise of multi-employer schemes, some of which are master-trusts. **Multi-employer schemes** are schemes that offer the same terms to every member regardless of whether they join the scheme as part of a group via their employer or singly as an employee or as a self-employed person. Some of these schemes are Defined Contribution Schemes run by an insurance company or pension provider. Others are **master trusts**, which are Defined Contribution schemes governed by a board of trustees who owe a fiduciary duty to members. These schemes may be stand-alone (such as NEST) or have the backing of a pension provider or insurance company (such as The People's Pension, NOW: Pensions).

Personal pensions can accept transfer values from occupational pensions or other individual arrangements and contracted-out rebates.

Charge cap

The Occupational Pension Schemes (Charges and Governance) Regulations 2015 introduced a cap on the charges of default funds used for automatic enrolment. This cap limits the total annual cost to members whose funds are invested in the default fund to 0.75% of funds under

[24] RN Third tier: Individual pension arrangements

management. The cap applies to all scheme and investment administration charges. Transaction costs (third-party costs generated when investments are sold and bought on the market) are excluded from the charge cap.[25]

Withdrawing Retirement Income
People are allowed to withdraw pension savings after the age of 55 rising to age 57 in 2028.[26] Before age 55 they can withdraw pension savings but will incur a tax charge of 55%.

Prior to 6 April 2015 people over the age of 55 could choose one or a combination of following options:

- Taking a 25% tax-free cash lump sum (provided the scheme rules allowed it). If an individual's entire pension fund was less than the trivial commutation limit (set at £30,000 from 27 March 2014),[27] it was possible to 'trivially commute' and take the whole fund as a lump sum, with 25% being tax-free and the remainder taxed at their marginal rate.
- Investing some or all of their fund for some part or all of their retirement in an income drawdown account (while taking an income from it, capped at 150% of an equivalent annuity);
- Purchasing an annuity. An insurance product that pays an income from the date of purchase until the date of death.[28]
- Withdrawing their fund in unlimited amounts provided that individuals can demonstrate a secured guaranteed lifetime pension income of at least £20,000 per year.[29]

People can now access DC pension savings flexibly from age 55
The Government announced in the 2014 Budget that, from 6 April 2015, individuals will be able to flexibly access DC pension savings from age 55. This means that at age 55, people can still take a 25% tax-free lump sum if they wish to (and if scheme rules allow) however they are not required to do so in order to access their pension savings. The options open to people with DC savings are limited only by the products available and the amount of savings people have. They are also governed by taxation.

Those with DB pension savings may not use flexible access unless they transfer their DB entitlement into a DC scheme first. Some DB schemes in the public sector do not allow transfers.

[25] www.gov.uk/government/uploads/system/uploads/attachment_data/file/420215/charge-cap-guidance-apr-2015.pdf
[26] Budget 2014
[27] The trivial commutation has previously been set at 1% of the Lifetime Allowance (currently £1.8m) however it has been decoupled from the lifetime allowance from 2012 HMT (2010) *Restricting pensions tax relief through existing allowances: a summary of the discussion document responses*, p. 26.
[28] An annuity insures against an individual's money running out because he or she lives longer than expected
[29] HMT (2011). *Removing the Effective Requirement to Annuitise by Age 75,* p.2. webarchive.nationalarchives.gov.uk/20130129110402; ww.hm-treasury.gov.uk/d/pensions_annuitisation.pdf

People with DC savings may, at age 55, do one or a combination of the following, (though this list is not exhaustive as the retirement income market is still evolving in light of the new policy):

- Leave their pension fund invested and withdraw unlimited amounts, taxed at an individual's marginal rate.
- Purchase a retirement income product including a lifetime annuity, a fixed-term or deferred annuity or income drawdown, without a cap on withdrawal amounts.
- Purchase a product such as longevity insurance.

Automatic enrolment into pension schemes from 2012

The previous Labour Government acted on the recommendations of the Pensions Commission (who reported in 2005)[30] and legislated in the Pensions Act 2008 for the introduction of automatic enrolment into private pensions. Automatic enrolment began "staging" in October 2012. Employees between age 22 and State Pension Age are eligible for automatic enrolment into a scheme chosen by the employer, with employees having the right to opt-out. The earnings threshold above which every employee should be auto-enrolled is £10,000 in 2014/15 and 2015/16. Contributions become payable on band earnings over £5,824 and up to a limit of £42,385 (2015/16).[31]

- Large employers with 250 or more employees were required to auto-enrol their eligible employees between October 2012 and February 2014.
- Medium sized employers with 50 to 249 employees had automatic enrolment dates between 1 April 2014 and 1 April 2015.
- Small employers with fewer than 50 employees have automatic enrolment dates between 1 June 2015 and 1 April 2017.
- New employers setting up business from 1 April 2012 and up to and including 30 September 2017 will have automatic enrolment dates between 1 May 2017 and 1 February 2018.

The required level of contributions that employers and employees must make into a pension scheme (if employees remain opted in) is being phased in between 2012 and 2018 to reach 8% minimum total contributions of band earnings by 2018.[32] This 8% will be made up of a minimum 3% from the employer and the remainder from the employee and the Government (through tax relief).[33] If the employer decides to contribute the legal minimum of 3% of band earnings, then employees who do not opt out will have to contribute 4% and the Government will contribute 1% through tax relief.[34] However, it will be up to employers to decide whether they want to contribute the legal minimum or more. If

[30] Pensions Commission (2005) *A New Pension Settlement for the Twenty-First Century.*
[31] www.thepensionsregulator.gov.uk/employers/automatic-enrolment-earnings-threshold.aspx
[32] DWP (2012) *Revised implementation proposals for workplace pension reform* July 2012, para 7
[33] The tax relief may be higher for those people who pay higher-rate tax
[34] The tax relief may be higher for those people who pay higher-rate tax

they contribute more than 4%, that could reduce the amount that employees are required to contribute.

National Employment Savings Trust (NEST)
The Pensions Act 2008 also legislated for the introduction of a new, low-cost, national pension saving scheme called NEST (National Employment Savings Trust). Employers who do not offer an occupational pension, stakeholder or other qualifying pension scheme are able to auto-enrol their employees into NEST, provided that the employee's earnings are above the automatic enrolment threshold of £10,000 in 2015/16. Employees with earnings below this level will be permitted to opt in to the scheme on a voluntary basis. There will be a total contributions limit, by or on behalf of a member of £4,700 a year (2015/16).

NEST has a low-charging structure. Members pay an Annual Management Charge of 0.3% of the fund per year and a 1.8% charge on contributions. Once NEST's start-up costs have been recovered, it is intended that the contribution charge will be dropped.[35]

There are currently restrictions on the amount of contributions that can be made into NEST and on individuals transferring pension funds into and out of NEST, except for annuity purchase, where a pension is shared through a divorce settlement or where an individual has been in an occupational pension scheme for less than two years. Following a call for evidence on these restrictions,[36] the Government has announced that the annual contributions limit will be lifted from April 2017, and that the restrictions on individual transfers will be removed in line with the introduction of automatic transfers. There is no intention to lift any restrictions on bulk transfers.[37]

NEST is not the only option for employers who do not offer a pension scheme. Other pension scheme master trusts have been set up in the private sector that aim to provide a pension scheme eligible for automatic enrolment. These include Now Pensions and The People's Pension.

Tax Changes
The Finance Act 2004, which took effect from 6 April 2006, included a number of amendments designed to simplify the taxation of the UK private pension regime, effectively capturing all pensions under a single

[35] See NEST (2012) *Low charges for future members of NEST.* www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/low-charges-for-future-members-of-NEST,PDF.pdf
[36] DWP (2012) *Supporting automatic enrolment*
[37] DWP (2013) Supporting automatic enrolment The Government response to the call for evidence on the impact of the annual contribution limit and the transfer restrictions on NEST: www.gov.uk/government/uploads/system/uploads/attachment_data/file/211063/nest-automatic-enrolment-call-for-evidence-response.pdf; www.gov.uk/government/news/victory-for-consumers-as-pension-saving-limits-to-be-scrapped

set of rules.[38] The amount by which an individual can benefit from tax advantages is controlled by two 'allowances': annual and lifetime. These allowances apply to each individual, and across all registered pension schemes that the individual uses for providing benefits, regardless of the time of joining.[39]

An individual can make contributions to any number of private pension schemes and receive tax relief on the amount saved in that year up to the annual allowance (AA). The AA for 2015/16 is £40,000.[40] Contributions above this level are taxed at an individual's marginal tax rate.

The Lifetime Allowance is applied when the individual begins to receive a benefit from his or her pension saving. If the value of the pension saving at this time is above the Lifetime Allowance (£1.25 million for 2015/16),[41] an additional tax charge is applied. The Lifetime Allowance will be reduced to £1 million in April 2016.[42]

[38] Inland Revenue (IR) (2003) *Simplifying the taxation of pension: the Government's Proposals* and Her Majesty's Treasury (HMT) (2004) *Prudence for a purpose: A Britain of stability and strength*, Budget report webarchive.nationalarchives.gov.uk/20130129110402; www.hm-treasury.gov.uk/budget/budget_04/budget_report/bud_bud04_repindex.cfm
[39] Although exemptions to the lifetime allowance are available to protect existing rights
[40] www.hmrc.gov.uk/pensionschemes/understanding-aa.htm
[41] www.hmrc.gov.uk/pensionschemes/understanding-la.htm
[42] www.gov.uk/government/publications/budget-2015-hm-revenue-and-customs-overview/hmrc-overview#savings-personal-tax-national-insurance-and-pensions

Reference note index

First tier provision

Second tier provision

Third tier provision

First tier: Eligibility for Basic State Pension

The Basic State Pension (BSP) is based on an individual's National Insurance (NI) contribution record (Chart 2). Any tax year in which an individual makes, or is credited with making, sufficient NI contributions is known as a qualifying year.

Employees make Class 1 contributions when their weekly earnings exceed the 'Primary Threshold' (PT) of £155 a week.[43] If they earn less than the PT but more than the 'Lower Earnings Limit' (LEL) of £112 a week, then they do not make Class 1 contributions but are credited for the BSP.[44] The self-employed make flat–rate Class 2 contributions of £2.80 a week.[45] Class 3 voluntary contributions, of £14.10 a week, are paid by those who wish to protect their entitlement and have not paid enough Class 1 or Class 2 contributions. Class 3 payments must generally be made within 6 years from the end of the tax year for which payment is being made.[46]

Chart 2

How National Insurance Contributions work

PENSIONS POLICY INSTITUTE PPI

NIC class	Who pays this class	What this entitles people to
Class 1	Paid by employers at a rate of 13.8% and employees aged between 16 and SPA who earn over the Primary Earnings Threshold (PET) at a rate of 12% and at a rate of 2% for earnings over the Upper Earnings Limit (UEL). People who earn at or above the Lower Earnings Limit (LEL) (£112 per week) but below the PT (£155 per week) are not required to pay but are treated as having paid NICs.	Each qualifying year counts towards an individual's pension entitlement and is used to calculate how much Basic State Pension (and Second State Pension) they will receive. People who earn below the LEL do not accrue entitlement to Basic State Pension
Class 2	Paid by people who are self employed at a fixed rate, people on low earnings can apply for exemption	Each Class 2 contribution is treated as one week of earnings at the LEL
Class 3	Voluntary contributions people can pay in order to fill gaps in their contribution record.	Can fill in gaps of full or partial years in order to make those years qualifying years for State Pension entitlement
Class 4	Additional contributions paid by self-employed people (as well as Class 2 NICs) at a rate of 9% on profits between the Lower Profits Limit and Upper Profits Limit (UPL) and 2% on profits above the UPL	Does not count towards qualifying years

[43] www.hmrc.gov.uk/rates/nic.htm
[44] From April 2011
[45] Special Class 2 rates apply for fishermen and volunteer development workers. The self-employed also make class 4 contributions, which are earnings-related but do not affect BSP entitlement.
[46] People were permitted to make back payments for more than 6 years if the payments were for the tax years 1996/1997 through to 2001/2002, and these payments were made by April 2009 or April 2010 depending on when people reach SPA. For detailed explanation www.hmrc.gov.uk/ni/volcontr/whentop-up.htm

There are 19 activities that can credit someone into the Basic State Pension without their having to pay contributions. Credit will be given if, for instance, an individual is entitled to Statutory Sick Pay or Statutory Maternity, Paternity or Adoption Pay, Jobseekers Allowance, Employment and Support Allowance, or Unemployability Supplement or Allowance, Carer's Allowance, or for men aged between women's SPA and to 65 with incomes below a certain level.[47]

No qualifying years are earned and no credit is earned if a married woman or widow is paying reduced-rate NI contributions.[48]

Introduction of the New State Pension

The Pensions Act 2014 contains the primary legislation setting out the New State Pension. The New State Pension will be set at a level above Guarantee Credit, which is currently £151.20 a week. State pension entitlements under the old system will be recognised.[49] The New State Pension will only be available to pensioners retiring after the date of implementation in April 2016.

There are differences between the qualification requirements under the New State Pension and the current system: for example, under the New State Pension system, 35 years of National Insurance Contributions or credits will be required for an individual to receive a full rate of pension, compared to 30 years under the current system; under the New State Pension system people will need a minimum of 10 qualifying years of contributions or credits to qualify for any state pension, while under the current system there is no minimum.

Currently, DB schemes can be contracted out of the State Second Pension (S2P), and employers who do so receive a rebate on their National Insurance Contributions. Under the New State Pension, further accruals of S2P entitlement would be disallowed and schemes would no longer be able to contract out.

Abolishing contracting out will mean that employers are required to pay higher national insurance contributions on behalf of their employees; an increase for each employee who is currently contracted-out of 3.4 per

[47] www.gov.uk/national-insurance-credits/eligibility
[48] Between 1948 and 1978 married women could elect to pay a reduced rate of NI contributions, known as the 'Married Women's Reduced Rate Election'. By electing to pay the reduced rate, women forfeited the right to a pension based on their own contributions and instead relied on their husband's contribution record. The wife would then receive a pension once the husband reached 65 at the rate of 60% of the husband's pension. The option to elect to pay the reduced rate ceased to be available in 1977. Entitlement to the option is lost if an individual is not working for more than 2 complete tax years. Alternatively, individuals can elect to recommence paying the full rate. PPI calculations based on data provided by DWP estimate that in 2003 around 60,000 women were still paying at the reduced rate (Briefing Note 11, July 2004). This figure is likely to have reduced since 2003. D the figure for 2013 is 3,000, webarchive.nationalarchives.gov.uk/20130505070614/https:/www.gov.uk/government/uploads/system/uploads/attachment_data/file/181235/derived-inherited-entitlement.pdf#page=8 p. 17
[49] *Pensions Act 2014* www.legislation.gov.uk/ukpga/2014/19/contents/enacted

cent of relevant earnings.

Previously contracted-out employees will be required to pay full NI contributions in line with other employees. This means an increase in the contributions that they pay equivalent to 1.4 per cent of relevant earnings (between the Lower Earnings Limit and the Upper Accrual Point).

The transition process will translate people's pre-implementation National Insurance records into a simple New State Pension starting amount, known as the 'foundation amount' – those people with a foundation amount that is less than the full level of the New State Pension will be able to take it up to the full level if they have sufficient qualifying years. Where an individual has previously been contracted out, a deduction will be applied to the foundation amount.

The Pensions Act 2014 also provides for the abolition of the Savings Credit element of Pension Credit for people who reach pensionable age on or after the introduction of the New State Pension.

Means-tested support will continue to be available through the Guarantee Credit element of Pension Credit alongside Housing Benefit, Council Tax Reduction and other income and disability related benefits. In addition, for a transitional period of 5 years from implementation, support will be retained for those people who may have been eligible for Savings Credit under the old system.

Under the current system, some people receive a state pension based on their partner's National Insurance contributions. These include individuals who are expecting to receive a pension based on their spouse or civil partner's National Insurance contributions and married women who paid reduced rates of National Insurance on the assumption that they would receive a derived pension based on their husband's contributions. However, the New State Pension will not include these provisions. People who retire under the current system are able to use these provisions even if their spouse or partner is in the New State Pension system, however, the government will only use the NI records of an individual's spouse or civil partner up to and including the tax year before the implementation of the New State Pension to calculate any derived entitlement.

Under the measures set out in the Pensions Act 2014 those who reach SPA under the New State Pension will not be able to claim derived entitlement on the basis of their partner's state pension entitlement. However, women who paid reduced rates of National Insurance contributions at any point during the 35 years before their SPA will be able to claim an amount equivalent to the full rate of the 'married woman's' basic pension rate, ensuring that they are not worse off under the new rules.

Home Responsibilities Protection (HRP) was introduced in 1978 and, for people reaching SPA before April 2010, reduced the number of years of contributions required to secure a full BSP. Protection was given for those complete tax years where an individual was caring for children or an older or a disabled person.

There were some changes in the Pensions Act 2007 that affect people who reach SPA between 6 April 2010 and April 2016. These people:

- Will be able to earn positive credits towards BSP rather than HRP reductions. The outcome for individuals under a credit system is more generous and simplifies the way entitlement is calculated.
- Only need 30 qualifying years to be eligible for the full Basic State Pension, while people who reached State Pension Age before 6 April 2010 still need to have contributed for 39 years (for women) or 44 years (for men) to qualify for a full Basic State Pension.
- Will receive a proportion of the full BSP for every contributing year, as the 25% minimum contribution limit is abolished.

Carers now receive *weekly* contribution credits for any week in which they are:

- Awarded child benefit; or
- A foster parent for a child under the age of 12; or
- Engaged in caring within the meaning given in regulations (people caring for one sick or severely disabled person for 20 hours or more per week will qualify for credit, subject to an appropriate validation process).

This change means that in any year, individuals can combine *caring credits* with *NI contributions* to build up a qualifying year. Credits for people who are caring for children are awarded until the youngest child reaches 12 years (down from 16 years), aligning the rules for Basic State Pension and State Second Pension (discussed in the next section).

Grandparents of working age who care for grandchildren for 20 hours or more per week are also eligible to receive caring credits that count towards their BSP entitlement.

People reaching SPA before 2010
For men who reached State Pension Age before 6 April 2010, the full BSP of £115.95 a week is payable with at least 44 qualifying years of National Insurance contributions. For women born prior to 6 April 1950 the full BSP is payable with at least 39 qualifying years.

A proportionate benefit is payable if the number of qualifying years is less than that needed for the maximum. For example, a woman who retired before 6 April 2010 with a 30 year contribution record currently receives a BSP of £89.19 a week ((30/39) * £115.95).[50] However, if the number of qualifying years at retirement was less than 25% of the amount required for a maximum BSP then no BSP benefit is payable, for a person who reached SPA before 6 April 2010.

If a person[51] cared for a child until the child reached age 16 the requirement for a maximum BSP would reduce from 39 qualifying years to 24. HRP did not give complete protection, as it did not reduce the number of qualifying years required for a full BSP below 20 years.

[50] Assuming no Home Responsibilities Protection is awarded
[51] Although most recipients are women, HRP is unisex - it is available to the person to whom child benefit is payable

First tier: Categories of Basic State Pension

There are five categories of Basic State Pension (BSP) provided by the state:

- Category A is based on the individual's contributions
- Category B is based on a spouse's or civil partner's qualifying years
- Category C is non-contributory, and is payable to widows of men who were over age 65 on 5 July 1948
- Category D is non-contributory and is payable to people over age 80 who satisfy certain residency conditions and fail to qualify for a category A or B pension, or receive less than the non-contributory rate
- Age Addition is non-contributory and is payable to all recipients of state pensions aged 80 or above

Category A pension

Category A pension is contributory and is based on the individual's contribution history. Where an individual has an incomplete contribution record, and reaches SPA before April 2016, then the qualifying years of a spouse or former spouse (separated through either bereavement or divorce) can be substituted to provide a higher BSP.

Changes in eligibility criteria for Category A pension[52]

For people reaching State Pension Age before 6 April 2010 and for those claiming bereavement benefits, past contribution conditions will continue to apply.

For those reaching State Pension Age from 6 April 2010, the number of years needed to qualify for a full category A pension is reduced from 44 years for a man and 39 years for a woman to 30 qualifying years for men and women alike. A person who has less than 30 qualifying years will be entitled to a proportion of the full BSP for each qualifying year they have built up.

Parents and carers are also allowed to build up entitlement to a category A pension through credits. Parents or guardians (awarded child benefit for a child aged under 12), a registered foster parent or a carer providing care (for one or more severely disabled persons or caring for a child under 12) reaching SPA from 6 April 2010 will be able to build up credits towards a category A pension.

For those reaching SPA from 6 April 2010, each complete year (subject to a limit) of Home Responsibilities Protection awarded under the existing rules of the scheme will be converted into a qualifying year for BSP.

[52] The changes described in this section result from legislation in the Pensions Act 2007 and announcements in Budget 2009.

From 2011, grandparents of working age who care for grandchildren for 20 hours or more per week are also be eligible to build up entitlement to a category A pension through credits.[53]

Category B pension

Category B pension is contributory and is based solely on a spouse's or civil partner's qualifying years and earnings. Previously it was only payable to married women, widows and widowers but from 6 April 2010 both men and women are able to claim BSP based on their spouse's or partner's NI record if this is better than their own.

Changes to eligibility for Category B pension[54]

From 6 April 2010 people can claim category B pension even if their spouse has deferred their own category A claim. Changes also allow the spouse or partner of a carer to build up entitlement to an associated category B pension. However, as a result of reforms to the state pension, the extent to which people will be reliant on category B pensions derived from their spouse's or partner's contributions will be significantly reduced in future.

Married couples

If both husband and wife have a satisfactory NI contribution record then they will each receive a full BSP when they reach SPA. However, if the wife is entitled to less than 60% of the full BSP and she is over SPA, she may be able to claim a composite category A and category B pension based on her husband's contribution record, which could increase her pension to 60% of the full rate.

Abolishment of Adult Dependency Increases

Adult Dependency Increases for dependants under SPA were abolished from 6 April 2010.[55] Provisions will be made to protect entitlements up to 5 April 2020.

Example (under the rules currently in place)

George and Elizabeth are a married couple who are both over state pension age. George has a full NI contribution record and receives the full BSP of £115.95 a week (category A). In comparison Elizabeth has an incomplete record and based on her contributions would only receive £30.00 a week (category A). However she can claim an additional £39.50 a week (category B) based on George's record giving a total weekly income of £185.45 for the couple.

Once Elizabeth reaches SPA the full £185.45 is payable to the couple even if she continues to work. From that date £115.95 would be payable to George and £69.50 would be payable to Elizabeth (£185.45 - £115.95 = £69.50).

[53] Budget 2009 speech, webarchive.nationalarchives.gov.uk/20130129110402; www.hm-treasury.gov.uk/bud_bud09_speech.htm
[54] Legislated in the Pensions Act 2007
[55] Legislated in the Pensions Act 2007

Category C pension

Category C pensions are now obsolete and are being gradually phased out (there were around 20 women in receipt of Category C pension in November 2014).[56] These are payable at the rate of 60% of the full BSP to men aged over 65 on 5 July 1948 or to widows of men who were aged over 65 in July 1948.

Category D pension

A non-contributory pension, equivalent to the dependent adult's addition, is awarded to those who:

- are aged 80 or above, and
- have been resident in the UK for at least 10 years in the previous 20 and
- receive either no BSP or less than the dependent adult's addition.

This is sometimes called the 'Over 80 Pension' and it amounts to £69.50 a week in 2015/16. If the person is on a reduced pension, he/she will receive the difference between £69.50 and the reduced BSP.[57]

Age addition

An age addition of 25p a week is payable to all recipients of BSP aged 80 or over. When it was introduced in 1971 the full BSP was £6.00 – effectively a 4.2% enhancement. Subsequently, the age addition has not been increased, and so is now only a 0.2% enhancement.

[56] DWP tab tool – state pension sourced: 10.06.15
[57] www.gov.uk/over-80-pension/overview

First tier: State Pension Age

The State Pension Age (SPA) is the minimum legal age at which a Basic State Pension can be claimed. The SPA depends on an individual's birth date. It is currently 65 years for men. Until 5 April 2010 SPA for women was 60 years. Under the provisions of the Pensions Act 1995 and the Pensions Act 2011, SPA for women is increasing from April 2010 in a series of steps to age 65 by November 2018 when it will be equal for both men and women.

The Pensions Act 2007 legislated for the increase in SPA for both men and women to 66 between April 2024 and April 2026. However, the Pensions Act 2011 brought forward the increase in SPA from age 65 to 66 to occur by October 2020. Thus, by October 2020 the SPA for both men and women will be age 66; this is five and a half years earlier than under previous legislation.[58]

For individuals born after 5 November 1954, their SPA will be at least age 66. The Pensions Act 2007 also legislated for further increases in SPA to 67 between 2034 and 2036 and to 68 between 2044 and 2046. However, the Pensions Act 2014 included provisions that the rise to age 67 will now occur between 2026 and 2028.

Bringing forward the SPA rise to 68 and the mechanism for determining future rises

SPA is currently scheduled to rise from age 67 to age 68 between 2044 and 2046 for both men and women, however the Government intends to review the timescale for the rise to age 68.[59] The Pensions Act 2014 sets out the Government's plans for the SPA in the future.[60] This includes a review of the SPA every 5 years, the review to be based around the principle that people should expect to spend a certain proportion of their adult life in retirement (based on analysis provided by the Government Actuary's Department and an independently-led body). For this purpose adult life is defined as starting at age 20.[61] In the Autumn Statement 2013, the Chancellor suggested this might result in the SPA increasing to age 68 by the mid-2030s and to 69 by the late 2040s.[62]

[58] For specific information on the SPA under the new rules depending on the date of birth, check the State Pension Age calculator: www.gov.uk/calculate-state-pension
[59] DWP (2010) *A sustainable State Pension: when the State Pension age will increase to 66* www.official-documents.gov.uk/document/cm79/7956/7956.pdf
[60] *Pensions Act 2014* www.legislation.gov.uk/ukpga/2014/19/contents/enacted
[61] DWP (2013) *The core principle underpinning future State Pension age rises: DWP background note*
[62] HM Treasury (2013) *Autumn Statement*

Table 1 compares the effects of increases in SPA for women under the Pensions Act 2011 provisions, compared to previous legislation, according to birth date.

Table 1: Comparing the effects of Pensions Act 1995 and Pensions Act 2011 provisions on womens' SPA

	Pensions Act 1995		Pensions Act 2011	
Date of Birth	**State Pension Date**	**State Pension Age**	**State Pension Date**	**State Pension Age**
6 March 1950 – 5 April 1950	6 April 2010	60 yrs 1 mth – 60 yrs	6 April 2010	60 yrs 1 mth – 60 yrs
6 April 1950 – 5 May 1950	6 June 2010	60 yrs 2 mths – 60 yrs 1 mth	6 June 2010	60 yrs 2 mths – 60 yrs 1 mth
6 May 1950 – 5 June 1950	6 Aug 2010	60 yrs – 3 mths – 60 yrs 2 mths	6 Aug 2010	60 yrs – 3 mths – 60 yrs 2 mths
6 March 1953 – 5 April 1953	6 April 2016	63 yrs 1 mth – 63 yrs 0 mths	6 April 2016	63 yrs 1 mth– 63 yrs 0 mths
6 April 1953 – 5 May 1953	6 June 2016	63 yrs 2 mths – 63 yrs 1 mth	6 July 2016	63 yrs 3 mths – 63 yrs 2 mths
6 October 1953 – 5 Nov 1953	6 Jun 2017	63 yrs 8 mths – 63 yrs 7 mths	6 July 2018	64 yrs 9 mths – 64 yrs 8 mths
6 Nov 1953 - 5 Dec. 1953	6 Aug 2017	63 yrs 9 mths – 63 yrs 8 mths	6 Nov 2018	65 yrs – 64 yrs 11 mths
6 Dec 1953 – 5 Jan 1954	6 Sept 2017	63 yrs 10 mths – 63 yrs 9 mths	6 March 2019	65 yrs 3 mths – 65 yrs 2 mths
6 Jan 1954 – 5 Feb 1954	6 Nov 2017	63 yrs 11 mths – 63 yrs 10 mths	6 May 2019	65 yrs 4 mths – 65 yrs 3 mths
6 April 1954 – 5 May 1954	6 May 2018	64 yrs 1 mths – 64 yrs	6 Nov 2020	65 yrs 7 mths – 65 yrs 6 mths
6 May 1954 to 5 June 1954	6 July 2018	64 yrs 2 mths – 64 yrs 1 mth	6 Jan 2020	65 yrs 8 mths – 65 yrs 7 mths
6 Aug 1954 to 5 Sept 1954	6 Jan 2019	64 yrs 5 mths – 64 yrs 4 mth	6 July 2020	65 yrs 11 mths – 65 yrs 10 mths
6 Sept 1954 to 5 Oct 1954	6 Mar 2019	64 yrs 6 mths – 64 yrs 5 mth	6 Sept 2020	66yrs – 65 yrs 11 mths
6 Oct 1954 to 5 Nov 1954	6 May 2019	64 yrs 7 mths – 64 yrs 6 mth	66th birthday	66yrs

First tier: Deferral of state pensions

Individuals can choose to defer the commencement of their BSP in return for an enhanced pension,[63] through the award of increments, or as a one-off lump sum.[64]

For each 5 weeks of deferral, people can receive an increase of 1% in their pension. This is equivalent to an increase of around 10.4% for each year people defer.

Increments can be earned after payments have started if recipients request that the Department for Work and Pensions cease payments. Increments will be earned at the same rate.

Similar rules are in place for other state pensions including the Graduated Retirement Benefit, SERPS and S2P (discussed in later sections). However, individuals must defer all state pension benefits – they cannot elect for instance to defer BSP but start receiving SERPS.

While benefit is being deferred, the amount not claimed is still counted as income for Pension Credit and other means-tested benefits.

Benefit that has been deferred for 12 consecutive months from April 2005 can be taken as either a one-off lump sum payment or an increase in future pension payments. In the case of a lump sum, the deferred benefit will accrue interest at 2% above the Bank of England Base Interest Rate, and the whole of the resulting lump sum will be taxable at the marginal rate of tax paid by the pensioner on his or her other income.[65] Because of the interest rate available, there can be a financial gain from deferring and taking a lump sum. The actual gain is not the full value of the lump sum (as it can be claimed and invested instead) but the value of any extra interest over and above what could be gained from claiming the pension and investing it. If the pension could be taken and invested at a higher rate than the 2% above the Bank of England base rate, it would suggest that deferring might not be cost effective.

[63]Deferring your State Pension: leaflet. www.gov.uk/government/uploads/system/uploads/attachment_data/file/299286/dwp024-apr-14.pdf
[64] Increments can also be awarded if payment is delayed for other reasons, such as a delay in returning the forms, or the Department for Work and Pensions not being aware of a change of address. Whatever the reason for the delay, individuals can only receive a 'back-payment' of up to 3 months of the missed payments.
[65] Even if some of the lump sum would normally have fallen in a higher tax band

First tier: Impact of indexation of BSP

The rules for increasing BSP have undergone many changes over the last four decades.

- Before 1974 BSP was increased on an ad-hoc basis. For instance in November 1969 it was increased from £4.50 to £5.00 a week and then not increased until September 1971 when it was increased to £6.00 a week.
- From 1974 to 1979 it was increased each year by the greater of the increase in National Average Earnings (NAE) and the Retail Prices Index (RPI).
- From 1979 to 2000 it was increased by the rise in RPI – from 1979 to 1983 on a forecasted basis and from 1983 on a historic basis.

The Social Security Administration Act of 1992 first introduced statutory uprating. This means that since 1992, BSP was increased each April by the increase in the RPI for the 12 months to the previous September.

Although the purpose of the statutory uprating is to increase BSP annually in line with the RPI, prior to April 2011, and after 2001, the BSP was increased by the greater of 2.5% or the RPI. The net effect is that although the value of the BSP increased in price terms, when compared to National Average Earnings (NAE) its value has gradually eroded since 1979 (Table 2). Under previous policy BSP would have continued to erode relative to NAE until at least 2012.[66]

Changes to BSP uprating

From April 2011 the BSP has been uprated by the higher of 2.5%, earnings, or prices (a mechanism known as the "triple lock"). The Consumer Prices Index (CPI), rather than the Retail Price Index (RPI) is used to consider price inflation. Table 2 shows the impact of the new mechanism by comparing the possible uprating under the triple lock with the projected growth in average earnings.

Sources

Office for National Statistics (ONS) (2009 and previous editions) *Annual survey of hours and earnings (ASHE) - 2009 Results*
www.statistics.gov.uk/StatBase/Product.asp?vlnk=15313
Office for National Statistics (ONS) (2010) *Retail Prices Index: monthly index numbers of retail prices 1948-2010*
www.statistics.gov.uk/STATBASE/Product.asp?vlnk=2176

[66] Assumptions – RPI increases each year by 2.87%. NAE increases each year by 2% above the RPI.

Table 2: Historical uprating of BSP in relation to National Average Earnings

	BSP – Weekly Amount	Adjusted to April 2015 prices	Weekly National Average Earnings	BSP as a percentage of NAE
October 1972	6.75	78.11	32.00	21.1%
July 1974	10.00	92.77	41.70	24.0%
November 1977	17.50	95.05	70.20	24.9%
November 1979	23.30	99.77	89.60	26.0%
November 1982	32.85	102.53	136.50	24.1%
April 1987	39.50	100.11	198.90	19.9%
April 1992	54.15	100.65	304.60	17.8%
April 2000	67.50	102.38	425.10	15.9%
April 2001	72.50	108.06	449.70	16.1%
April 2002	75.50	110.87	472.10	16.0%
April 2003	77.45	110.28	487.10	15.9%
April 2004	79.60	110.59	498.20	16.0%
April 2005	82.05	110.48	516.40	15.9%
April 2006	84.25	110.62	534.90	15.8%
April 2007	87.30	109.66	549.80	15.9%
April 2008	90.70	109.35	574.30	15.8%
April 2009	95.25	116.19	587.30	16.2%
April 2010	97.65	113.08	598.30	16.3%
April 2011	102.15	112.43	602.60	17.0%
April 2012	107.45	114.32	607.10	17.7%
April 2013	110.15	113.90	620.30	17.8%
April 2014	113.10	114.12	620.20	18.2%
April 2015	115.95	115.95	630.12	18.4%

Table 3: Projected uprating of BSP under the reformed (triple locked) system

Tax Year	BSP - Weekly Amount (Projected)	Weekly National Average Earnings (Projected)	Projected BSP as a percentage of NAE
2015	£115.95	£630	18.4%
2017	£121.82	£659	18.5%
2022	£148.20	£800	18.5%
2027	£186.46	£992	18.8%
2032	£234.60	£1,230	19.1%
2037	£295.16	£1,526	19.3%
2042	£371.35	£1,893	19.6%

First tier: Pension Credit

Pension Credit replaced the Minimum Income Guarantee (MIG) in October 2003. Pension Credit (PC) consists of two parts – Guarantee Credit (GC) which is similar to the MIG, and Savings Credit (SC).

Guarantee Credit
Guarantee Credit replaced the Minimum Income Guarantee (MIG) in October 2003. Guarantee Credit (GC) is the name used for the means-tested income support benefit for people over the women's SPA. It is payable from around age 62 in 2014 as a tax-free means-tested benefit – it is only paid to those with low incomes and with low savings.[67]

Its effect is redistributive – the benefit is paid for from taxes that are related to income and only paid to those on low income. From April 2014 GC 'guarantees' a minimum of £151.20 a week for single pensioners and a minimum of £230.85 a week for couples.

An individual or couple[68] is eligible for GC if they:
- Have an age equal to women's SPA (currently around 62½) or higher. This age is progressively increasing in line with the increase in women's SPA.
- are on a weekly income below the GC level of £151.20 a week for single pensioners and a minimum of £230.85 a week for couples, and
- are working less than 16 hours a week (and any partner working less than 24 hours a week).

Changes around eligibility for Pension Credit
The Welfare Reform Act 2012 stipulates that an individual over the SPA will not be entitled to Pension Credit if they have a spouse under the SPA.[69] Universal Credit is being rolled out gradually with plans to move most existing claimants to Universal Credit by the end of 2017. Once Universal Credit is fully rolled out, the younger partner will be able to claim Universal Credit for both people in the couple until they also reach the qualifying age for Guarantee Credit (currently 62½). However, Universal Credit may be paid at a lower rate than Pension Credit.

GC can be higher where:
- an individual (or an individual within a couple) is disabled and living either on their own or with another disabled person, or
- an individual (or an individual within a couple) is a carer getting Carer's Allowance, or

67 Savings consist of liquid assets, such as cash, building society and bank accounts, national savings, unit trusts and shares. It does not include the value of the home.
68 Married, Civil Partners, or living together as husband and wife or as civil partners
69 See UK Parliament (2012) *Welfare Reform Act*, Sch 2, 64 (1A) p. 124.
www.legislation.gov.uk/ukpga/2012/5/pdfs/ukpga_20120005_en.pdf

- where there are housing costs not fully covered by Housing Benefit.

Lower levels of benefit are paid if pensioners have savings of more than £10,000.[70] The assessed savings include: savings and investments, and any properties that are not the beneficiary's main home. GC is currently reduced by £1.00 a week for each £500 (or part thereof) in excess of £10,000. This is more generous than under the MIG.[71]

Savings Credit
Savings Credit (SC) attempts to encourage saving and ensure that anyone who has made some private saving for retirement will be better off than those who have not saved. However, those who do not have a full BSP will not receive credit for all of their savings. While GC is payable from women's SPA (currently around 62½), SC is only payable to pensioners from age 65.

SC pays a tax-free allowance of 60p per £1 for any income between the SC threshold and the GC threshold. This includes some income from ongoing employment, SERPS, Graduated Retirement Benefit, employer-sponsored pension schemes, personal pensions and notional income from savings. The maximum SC that can be received in 2015/16 is £14.82 for single pensioners and £17.43 for couples.

In 2015/16 the income above which people are no longer eligible to receive SC is around £188 for single pensioners and around £274 for couples.[72]

For 2015/16 the SC threshold for single pensioners is set at £126.50 a week and the SC threshold for couples is £201.80 a week.

Example
Dolly is currently aged 65. She is entitled to a BSP of £105.95 a week - £10 below the maximum entitlement for a single person. She also receives an occupational pension of £30.00 a week giving her a total weekly income of £135.95. She is entitled to a guaranteed element of £15.25 because she is over age 62½ (to increase her income to the Guarantee Credit level of £151.20 a week). She also receives a savings credit of £5.67 a week i.e. 60% of the excess above £126.50, giving her a total weekly income of £156.87.

[70] The amount of savings pensioners could have before their GC entitlement was reduced was £6,000 until November 2009 when it was raised to £10,000 - Budget 2009 speech, webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/bud_bud09_index.htm
[71] Under the previous legislation the MIG was reduced by £1.00 a week for each £250 in excess of £6,000.
[72] Income limits for single and pensioner couples could be higher if they qualify for a higher level of GC through severe disability, caring or housing costs.

Example

Table 4 below shows the impact of various levels of accrued savings for a single person receiving only the 2015/16 BSP of £115.95. In this table savings above £10,000 are considered when calculating assumed savings income.

Table 4: Interaction of accrued savings with Pension Credit

Savings	Assumed Savings Income	GC Benefit	Total Weekly BSP + GC
£0	£0.00	£35.25	£151.20
£10,000	£0.00	£35.25	£151.20
£12,000	£4.00	£31.25	£147.20
£14,000	£8.00	£27.25	£143.20
£16,000	£12.00	£23.25	£139.20
£18,000	£16.00	£19.25	£135.20
£20,000	£20.00	£15.25	£131.20
£22,000	£24.00	£11.25	£127.20
£24,000	£28.00	£7.25	£123.20

Table 5 shows the interaction of Guarantee Credit with Savings Credit for various levels of assessed income for single pensioners and pensioner couples. The incomes given represent the total income considered for Pension Credit purposes. It may include, for example, basic state pension, additional state pension, private pension income, savings converted into notional income calculated for the pension credit calculation. Savings Credit can increase up to £14.82 a week (for a single pensioner), when income is £151.20 a week, and then begins to tail off for higher levels of income. Table 5 shows in bold the weekly income value at which GC and SC become zero because of hitting the assessed income limit.

Table 5: Interaction of income with GC and SC in the 2015/16 Tax Year

Single Pensioner				Pensioner Couple			
Weekly Income	Guarantee Credit	Savings Credit	Total Income	Weekly Income	Guarantee Credit	Savings Credit	Total Income
£70.00	£81.20	£0.00	£151.20	£150.00	£80.85	£0.00	£230.85
£80.00	£71.20	£0.00	£151.20	£160.00	£70.85	£0.00	£230.85
£90.00	£61.20	£0.00	£151.20	£170.00	£60.85	£0.00	£230.85
£100.00	£51.20	£0.00	£151.20	£180.00	£50.85	£0.00	£230.85
£110.00	£41.20	£0.00	£151.20	£190.00	£40.85	£0.00	£230.85
£120.00	£31.20	£0.00	£151.20	£200.00	£30.85	£0.00	£230.85
£130.00	£21.20	£2.10	£153.30	£210.00	£20.85	£4.92	£235.77
£140.00	£11.20	£8.10	£159.30	£220.00	£10.85	£10.92	£241.77
£150.00	£1.20	£14.10	£165.30	£230.00	£0.85	£16.92	£247.77
£151.20	£0.00	£14.82	£166.02	£230.85	£0.00	£17.43	£248.28
£160.00	£0.00	£11.30	£171.30	£240.00	£0.00	£13.77	£253.77
£170.00	£0.00	£7.30	£177.30	£250.00	£0.00	£9.77	£259.77
£180.00	£0.00	£3.30	£183.30	£260.00	£0.00	£5.77	£265.77
£188.25	**£0.00**	**£0.00**	**£188.25**	£270.00	£0.00	£1.77	£271.77
£190.00	£0.00	£0.00	£190.00	**£274.43**	**£0.00**	**£0.00**	**£274.43**
£200.00	£0.00	£0.00	£200.00	£280.00	£0.00	£0.00	£280.00

First Tier: Housing Benefit

Housing Benefit (HB) is a means-tested benefit that is designed to help individuals in rented accommodation to pay for their rent. It is paid to single people or couples based on their income. This includes some income from employment, state and private pensions, notional income from capital and Savings Credit.

The maximum amount of benefit available is an amount equal to a person's (or couple's) share of the household's rent and is paid if claimants are also eligible for Guarantee Credit. In practice, the amount of rent that can be taken into account in the calculation of HB will be restricted if the amount of rent paid by the household is considered to be excessive.[73]

The amount of rent that is actually taken into account in the calculation of HB, after these restrictions have been applied, is called 'eligible rent'.

Housing Benefit is reduced once income reaches a personal allowance of £166.05 a week for singles and £248.30 for couples where one or both partners are aged over 65 (from April 2015). This is intentionally set to broadly equal the Guarantee Credit level (currently £151.20 a week from April 2015) plus the maximum amount of Savings Credit (£14.82 a week). As Savings Credit is taken into account for HB, this means that HB is withdrawn once an individual is no longer eligible for the Guarantee Credit.

If the claimant's income is above the personal allowance level, then the amount of Housing Benefit is reduced at the rate of 65p for every £1 of additional income. No benefit is payable if claimants have capital of more than £16,000, unless they are also eligible for Guarantee Credit. Higher personal allowances can apply for individuals who are eligible for premiums for Pension Credit.

The Welfare Reform Act 2007 legislated for the roll-out of Local Housing Allowance (LHA) across the private rented sector from 7 April 2008. LHA is a new way of working out how the amount of benefit is determined and in the mechanisms by which the benefit is delivered.

The maximum amount of Housing Benefit payable is the amount of rent that a particular person (or couple) pays, subject to a series of restrictions. LHA gives a claimant an allowance, based on the 30th percentile of market rents in the particular locality and on housing needs. The highest rents across the country are excluded from the calculation of the Local Housing

[73] For example, if the contractual rent is significantly above the market level. The size of the accommodation relative to the needs of the tenant may also be considered and rents will also be compared to 'local reference rates', which are calculated as the midpoint of a range of rents for properties of the same size in the locality.

Allowance in each area. Individuals can decide to live in more expensive accommodation than the allowance covers, if they can cover the difference, or live in cheaper accommodation.

The previous Coalition Government made changes to housing benefit from April 2011.[74] As a result:

- The Local Housing Allowance (LHA) is restricted to a maximum of four bedrooms for new and existing claimants.
- Weekly LHA rates are capped at £260.64 for a one bedroom property, £302.33 for two, £354.46 for three and £417.02 for a four bedroom property. The maximum rate of Housing Benefit is limited to the rate for a four bedroom property.
- LHA rates are based on the thirtieth percentile of rents of the local area rather than the median.
- From April 2013 LHA will be uprated by CPI.

The Welfare Reform Act 2012 introduced a restriction to Housing Benefit to allow for one bedroom for each person or couple living as part of the household, with some exceptions. Pensioners are currently exempt from this; however, as the state pension age increases those people affected by the increase may also face this restriction. Claimants will forego a fixed percentage of the Housing Benefit eligible rent; 14% of eligible rent for one bedroom and 25% for two or more extra bedrooms.

Other changes related to Housing Benefit have been introduced in phased stages. These include deductions to be made if there is another adult living in the claimant's home and the rate for room share.

Housing Benefit assessed under the Local Housing Allowance is paid directly to the claimant, rather than straight to the landlord as can be the case for some Housing Benefit claims as used to be the default. Under Universal Credit, which is being phased in at the moment, the housing element will be paid directly to the claimant even in the case of council tenants.

Example
Susan is a 65 year old single woman who does not own her own home. She rents a flat costing her £85 a week. Her income from state and private pensions is £145 a week, which would entitle her to £17.30 a week from Pension Credit (made up of £6.20 from the Guarantee Credit and £11.10 from Savings Credit). If Susan had no additional savings she would be entitled to have her whole rent paid by Housing Benefit.

On the other hand, if Susan had savings of £15,000 the first £10,000 of savings is disregarded, leaving Susan £5,000 to be considered. This is converted into a "tariff income" for calculation purposes at £1 for every £500 of savings, giving

[74] See UK Parliament (2012) *Welfare Reform Act*, p. 124.: www.legislation.gov.uk/ukpga/2012/5/pdfs/ukpga_20120005_en.pdf

Susan £10 of tariff income. This makes her income for Pension Credit calculations £155 (=£145 + £10). She would not receive income from the Guarantee Credit but her income from Savings Credit would be £13.30 a week.

Her deemed income in the calculation for her Housing Benefit entitlement would be £168.30 a week.

£168.30 = £13.30 (income from Savings Credit) + £145.00 (income from state and private pensions) + £10.00 (deemed income from savings. This is the same as the deemed income for pension credit because the calculation of tariff income from savings for housing benefit has the same savings disregard of £10,000[75])

*This is £2.25 above the personal allowance for Housing Benefit (£166.05 a week in 2015/16), which would reduce her income from Housing Benefit by £1.46 a week (£2.25 * 0.65). So Susan would receive Housing Benefit worth £83.54 a week towards the cost of her rent.*

If her savings were £16,000 or above, Susan would not be eligible to receive any Housing Benefit (since her savings would be above the £16,000 limit).

[75] DWP (2010) *Social Security Benefit Uprating*, p.1.

First Tier: Council Tax Reduction

Until April 2013, pensioners were able to access Council Tax Benefit, a means-tested benefit designed to help individuals pay their council tax. Like Housing Benefit, it was paid to singles or couples based on their income from employment, state and private pensions, notional income from capital and Savings Credit.

From April 2013, The Local Government Finance Account has required councils in England to design their own Council Tax Reduction Schemes. In this way Council Tax Reduction is no longer a national entitlement. However, the Government has stated that pensioners should not be worse off under this arrangement. For the purpose of Council Tax Reduction a pensioner is someone who has reached the qualifying age for Pension Credit, currently 62½. Therefore, the thresholds and maximums described below continue to apply.

The maximum amount of Council Tax Reduction payable is an amount equal to the person's (or couple's) liability to pay council tax, subject to certain restrictions. This amount is paid if the individual is eligible for Guarantee Credit.

Council Tax Reduction is reduced once income reaches a personal allowance of £166.05 a week for a single pensioner, £248.30 a week for a couple aged 65 and over, for 2015/16. If the claimant's income is above the personal allowance level, then the amount of Council Tax Reduction is reduced at the rate of 20p for every £1 of additional income. No benefit is payable if claimants have capital of more than £16,000, unless they are also eligible for Guarantee Credit.

There was a 'Band E restriction' under the national Council Tax Benefit scheme. The effect of this restriction was that claimants whose property fell into Bands F, G or H were awarded Council Tax Reduction as if their property was in Band E. Some councils restrict Council Tax Reduction awards up to the value of a certain Council Tax band.

Second Adult Rebate (SAR) is a means-tested benefit but it is not assessed on the income and capital of the person liable to claim it. It aims to compensate people who pay council tax but who were not able to claim a single person discount because there was a second adult present in their household.

A single person discount can reduce a person's liability to council tax by 25%, if they are the only adult living in the property. If a second adult is present, SAR can rebate up to 25% of the council tax paid by the claimant. A 25% rebate is paid if the second adult is in receipt of Income Support, Income-based Jobseeker's Allowance or Pension Credit, however this amount is reduced if the second adult has higher levels of income. If the second adult's gross weekly income is less than £187, the rebate is 15% and if it is between £187 and £243 the rebate is 7.5%.

Whenever someone claims main Council Tax Reduction, SAR is also calculated. The claimant is then awarded whichever benefit (main CTR or SAR) is most advantageous to them. In practice, there are very few awards of SAR.[76]

Example
Tim and Kate are a married couple and are both above age 65. Their Council Tax liability is £12.25 a week. Their combined income from state pensions is £235 a week, which would entitle them to £15.77 a week from Pension Credit (made up entirely of Savings Credit).

Even if they had no additional savings Tim and Kate would still not be entitled to a Council Tax rebate of 100% of their liability because their deemed income of £250.77 a week (£235 + £15.77) is above the personal allowance for couples of £248.30 a week in 2015/16. But they would be eligible to partial Council Tax Reduction.

*Their deemed income is therefore £2.47 above the personal allowance, which would reduce their income from Council Tax Reduction by £0.49 a week (£2.47 * 0.2). So Tim and Kate would receive a Council Tax rebate worth £11.76 a week.*

If Tim and Kate did have savings above the £16,000 limit, they would not be eligible to receive any Council Tax Reduction.

Source
Department for Work and Pensions (2014) *Proposed benefit and pension rates 2014 to 2015*
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/275291/Benefit_and_Pension_rates_2014-15.pdf

[76] The DWP is unable to confirm exact figures of how many people claim SAR, and has removed estimates from their publications

First tier: Other first tier benefits

Individually Assessed Benefits
Disability-related benefits such as Attendance Allowance are payable if individuals satisfy the qualifying criteria – for instance:

- Attendance Allowance - lower rate of £55.10 from April 2015 – payable if the individual needs personal care during either the day or the night. Attendance Allowance can only be claimed after age 65.
- Attendance Allowance - higher rate of £82.30 from April 2015 – payable if the individual needs personal care during both the day and the night.
- Disability Living Allowance – consists of two elements - a care component of between £21.80 and £82.30 a week from April 2015 for personal care, and a mobility component of between £21.80 and £57.45 a week from April 2015. Disability Living Allowance can only be newly claimed before age 65, although payment for continuous claims can continue after age 65.
- Carer's Allowance of £62.10 a week from April 2014 is payable to those spending at least 35 hours a week looking after someone receiving certain disability benefits including Attendance Allowance and Disability Living Allowance.[77]

Attendance Allowance and Disability Living Allowance are tax free, are not means-tested and do not count as income for the purposes of assessing eligibility for other benefits (such as Pension Credit, Housing Benefit and Council Tax Reduction).

Personal Independence Payment (PIP) is replacing Disability Living Allowance for those people aged 16 to 64. There is a staged timetable for this development; in 2013 PIP was introduced for new claimants. From 2013, DWP started to contact people aged 16 to 65 in receipt of DLA about transferring to PIP.[78]

Carer's Allowance is not payable to those who earn more than £110 a week or to those who receive benefits of £62.10 or more. The amount received can also be reduced if individuals receive other state benefits. Carer's Allowance is taken into account as income for the purposes of assessing eligibility for means-tested benefits, although an individual in receipt of Carer's Allowance may qualify for a carer premium in Pension Credit.

[77] Carer's Allowance is a maximum of £61.35 a week from April 2014, but is reduced by any other income the individual receives. Effectively this only benefits those carers with no retirement pension (mostly women) or a reduced rate of retirement pension.
[78] www.gov.uk/government/policies/simplifying-the-welfare-system-and-making-sure-work-pays/supporting-pages/introducing-personal-independence-payment

Near Universal Benefits
Paid irrespective of income or assets, including:

- Christmas Bonus - £10 per recipient of BSP - paid annually before Christmas.
- Winter Fuel Payment - £200 per household where at least one person is women's SPA or over, and £300 per household where at least one person is aged 80 or over - paid annually in December.[79] The qualifying age for this benefit increases in line with women's SPA.
- Free NHS prescriptions and eye tests for those over 60.
- Free TV Licences for those over 75.
- Free central heating installed for people receiving Pension Credit and discounts for other pensioners.
- Free off-peak nationwide bus travel for those aged over women's SPA, currently 62½.

Tax Allowances

- The personal allowance (amount of income receivable before income tax becomes payable) is £10,660 for people born before 6 April 1938, aged 77, with less than £27,700 in earnings.[80] Those born between 6 April 1938 and 5 April 1948 had an increased personal allowance up until 2014/15, but this has now been phased out. The allowance for everyone under age 77 is £10,600 in 2015/16.[81]
- The Government is removing the increased personal allowance for people aged over 77. The personal allowance for people already aged over 77 will be frozen at £10,660 until they meet the personal allowance level of under-77s.[82]
- The married couple's allowance is £8,355 for those born before 6 April 1935. Tax relief of 10% is given on income in this band. Where income exceeds £27,700 any married couple's allowance is reduced at the rate of £1 for every £2 of 'excess' income, to a minimum of £3,220.[83] There is no married couples allowance for those born after 6 April 1935.

[79] www.gov.uk/winter-fuel-payment
[80] For people with incomes over £27,000 their personal allowance is reduced by £1 for every £2 over the £27,000 limit until it reaches the personal allowance for those born after 6 April 1948.
[81] www.gov.uk/income-tax-rates
[82] As announced in Budget 2012
[83] This is the notional value of the married couple's allowance to those aged under 65, which was abolished with effect from the 2000/1 tax year

Second tier: Overview

The UK's second tier of state pension provision operates on an unfunded 'pay-as-you-go' contributory basis, through the National Insurance (NI) system. Benefits are payable from SPA, and can be deferred in the same way as Basic State Pension. The self-employed are currently excluded from second tier provision.

Introduction of the New State Pension
Currently, DB schemes can be contracted out of the State Second Pension (S2P), and employers who do so receive a rebate on their National Insurance Contributions. Under the New State Pension, further accruals of S2P entitlement would be disallowed and schemes would no longer be able to contract out.

The original aim of the second tier was to provide further pension income to employees in a way that is more closely related to their earnings level than the first tier. Contributions are made in proportion to earnings (in a band between minimum and maximum limits). Benefits reflect these contributions, so there is less redistribution (from those with higher incomes to those with lower incomes) than in the first tier.

Second tier provision in the UK has existed in three different guises since 1961:

- Graduated Retirement Benefit (GRB: 1961 to 1975)
- State Earnings Related Pension Scheme (SERPS: 1978 to 2002)
- State Second Pension (S2P: from April 2002)

Between 1975 and 1978, no additional state pension entitlement was accrued. Some of today's pensioners still receive small amounts of benefit from accrued rights to the **Graduated Retirement Benefit (GRB).** Further information on GRB is available in the Historical Annex that accompanies this document.[84]

The **State Earnings-Related Pension Scheme (SERPS)** is much more significant for current pensioners.

The original aim of SERPS was to provide a pension of 25% of band earnings.[85] Subsequent changes to SERPS have reduced the value of SERPS benefits. A detailed discussion of the changes SERPS has undergone is available in the Historical Annex.[86]

State Second Pension (S2P) started in 2002 as a replacement for SERPS. Significant pensions under S2P have yet to start payment. The main aim of

[84] www.pensionspolicyinstitute.org.uk
[85] Earnings between the Lower Earnings Limit and Upper Accrual Point
[86] www.pensionspolicyinstitute.org.uk

S2P is to target greater resources at the lower paid and some individuals who cannot work due to disability or caring responsibilities. It is therefore more redistributive than SERPS, and people working on low pay benefit more than they did under SERPS.

The pattern of accruing benefits under S2P is more complicated than in SERPS, being based originally on three earnings bands and three accrual rates, rather than one band and one accrual rate. As a result of provisions in the Pensions Act 2007, the earnings bands were reduced from three to two since April 2010. The original intention was to progressively transform S2P into a flat rate benefit by 2030; however, as a result of the introduction of the New State Pension in 2016, people will now be unable to accrue further entitlement to S2P after April 2016.

For low earners, a flat rate of S2P pension is accrued. Higher earners accrue an additional earnings-related benefit alongside the flat rate benefit. People in receipt of disability benefits or care-related benefits are credited into the flat rate part of S2P.

Current working age employees can only accrue entitlement to S2P as the SERPs scheme is closed to future accruals, however SERPs remains an important component of the income paid out to today’s pensioners and will continue to do so for many years.

This guide focusses mainly on S2P and its predecessor SERPS. A historical annex provides further background on the changes made to SERPs by successive Governments and on Graduated Retirement Benefit – the predecessor benefit to SERPs.

Second tier: State Second Pension (S2P)

State Second Pension (S2P) is an additional state pension scheme introduced by the Government in 2002 under the Child Support, Pensions and Social Security Act 2000, as the successor benefit to SERPS. The aim of S2P is to target greater resources at the lower-paid than SERPS did, and to provide pension benefits for some carers and individuals with a long-term disability.

Transition towards a New State Pension
After the New State Pension is introduced, people will no longer be able to accrue entitlement to S2P. However, people who have already accrued entitlement will have their entitlements recognised under the new system.

S2P is funded through National Insurance contributions on a pay-as-you-go basis. The pension is payable from SPA and is taxable. All employees are members of S2P, and earn S2P pension for any periods of employment, unless they:

- earn below the Lower Earnings Limit, or
- are aged over SPA, or
- are a married woman or widow paying reduced rate NI contributions, or
- are members of a contracted-out occupational pension scheme.

No S2P is earned for periods of self-employment or unemployment.

S2P pension at SPA is based on band earnings. Before 6 April 2010, there were three bands. Following provisions in the 2007 Pensions Act, the former second and third bands have been merged.[87] The band earnings and accrual rates are the following:

- Those earning between the Lower Earnings Limit (LEL) £5,824 a year (2015/16) and the Low Earnings Threshold (LET) of £15,300 a year (2015/16) are treated as if they earned £15,300. Benefit accrues at a flat rate of £93.60 indexed to National Average Earnings.[88]
- Those earning between £15,300 per year and the Upper Accrual Point (UAP) of £40,040 per year (2015/16) also accrue benefit but a rate of 10% of earnings within this band.
- Some carers[89] (caring for children under 12-years old or disabled relatives) and people with a long-term illness or disability will be treated as if they are employees earning at the LET.

[87] For the current earnings limits - www.hmrc.gov.uk/rates/nic.htm
[88] www.legislation.gov.uk/uksi/2015/185/pdfs/uksiem_20150185_en.pdf
[89] Before April 2010 not all carers could accrue benefits, as they had to have cared for the entire financial year. Shorter spells of caring or those that straddle two financial years did not qualify.

Changes in the Pensions Act 2007 increased the number of people accruing S2P. Starting in April 2010, the changes have allowed people to be deemed to be earning at the LET by combining earnings below the LET with a more generous system of weekly credits.

The new earnings credits, of 1/52 of the qualifying earnings factor for the year, are available in respect of each week in which the person was:

- awarded child benefit for a child under 12, or
- a foster parent, or
- caring for someone with a qualifying disability benefit for at least 20 hours a week, or
- entitled to Carer's Allowance, or
- entitled to Severe Disablement Allowance or long-term Incapacity Benefit.

Class 3A voluntary National Insurance contributions

Class 3A National Insurance contributions[90] are designed to help those people who have not been able to build up much additional State Pension but reach SPA before the introduction of the New State Pension.

People will be able to make Class 3A contributions from October 2015 and the offer will be open for 18 months.

Each Class 3A contribution will be used to acquire a unit of extra pension which will increase the individual's additional State Pension by £1 a week up to a cap of £25 per week.

The price has been set at an 'actuarially fair' rate and will therefore be lower for older pensioners than younger pensioners.

[90] www.gov.uk/government/uploads/system/uploads/attachment_data/file/265390/v2_mw__20131211_policy_brief_formatted_FINAL.pdf

Second tier: S2P accrual

Following provisions in the Pensions Act 2007, from April 2010, S2P band-earnings have been reduced to only two. The goal of these changes was to progressively move the S2P towards a flat rate benefit, though all S2P accrual will end after the introduction of the New State Pension. People who have already accrued entitlement will have their entitlements recognised under the new system.

The two band-earnings are the following:

- The first band is between the Lower Earnings Limit (LEL) and the Low Earnings Threshold (LET) (£5,824 to £15,300 from April 2015).
- The second band is between the LET and the Upper Accrual Point (UAP) (£15,300 to £40,040).

The accrual rate varies for each band. Until 5 April 2012, the accrual rate was 40% of earnings for the first band and 10% of earnings for the second band. From 6 April 2012, the accrual for earnings in the first band was switched to a flat rate.[91] From April 2015, the accrual rates for S2P are the following:

- A flat rate of £93.60 per year for earnings within the first band. This flat rate will be indexed to National Average Earnings.
- A rate of 10% of earnings per year for earnings within the second band.

At retirement the State Second Pension is calculated by dividing the total of the revalued accrual by the individual's potential working life from age 16 to SPA, or from 1978 to SPA, whichever is shorter.

The upper limit of the first band (LET = £15,300)[92] increases each year in line with national average earnings. The upper limit of the second band (UAP = £40,040) is fixed.

Where earnings are below the LET, individuals are treated as if they earned at the LET. Qualifying carers or disabled people are also treated as if they earned at the LET. If individuals have earnings below the LEL (£5,824 in 2015/16), then they do not accrue rights to S2P. Table 6 below shows the annual accrual to S2P for 2015/16 for different levels of earnings.

[91] These changes were introduced by Order 189: The Social Security Pensions (Flat Rate Accrual Amount), following the provisions of the Pensions Act 2007 of moving the S2P progressively towards a flat rate benefit. www.legislation.gov.uk/uksi/2012/189/pdfs/uksi_20120189_en.pdf

[92] www.legislation.gov.uk/uksi/2013/528/made

Table 6: S2P accrual – 2015/16[93]

Earnings from employment	Band earnings	S2P accrual (p.a.)
Carer - £0	-	£92
£3,000	-	£0
At LEL - £5,824	-	£92
£6,024	£200	£92
£10,000	£4,176	£92
At LET - £15,300	£9,476	£92
£19,000	£13,176	£100
£25,000	£19,176	£112
£34,300	£28,476	£131
£35,000	£29,176	£132
At UAP - £40,040	£34,216	£142
£50,000	£34,216	£142

[93] Assumes potentially 49 years of service

Second tier: State Earnings Related Pension Scheme (SERPS)

SERPS, the predecessor to State Second Pension, was introduced in 1978. It was established under the Social Security Pensions Act 1975 and was funded through National Insurance contributions on a pay-as-you-go basis. Subsequent changes have reduced the amount individuals can accrue through SERPS contributions, and from 2002 SERPS was replaced with State Second Pension.

SERPS was originally scheduled to provide a pension of 25% of band earnings – annual earnings up to a maximum of 53 times the weekly Upper Earnings Limit (UEL), and less a deduction of 52 times the weekly Lower Earnings Limit (LEL)[94] - linking the pension payable to earnings while in employment. The pension would be higher for higher earners, but capped.

SERPS is payable from SPA and is taxable. Once in payment, it increases in line with prices using the Retail Prices Index (RPI). However, unlike the previous policies for BSP, SERPS is not subject to a guaranteed minimum increase of 2.5% in times of low inflation. From April 2011 SERPS payments are uprated by the yearly rise in the Consumer Prices Index (CPI) instead of the Retail Price Index (RPI).[95]

All employees were members of SERPS, and will have earned SERPS entitlement for any periods of employment between 1978 and 2002, unless they:

- earned below the Lower Earnings Limit, or
- were aged over the SPA, or
- were a married woman or widow paying reduced rate NI contributions, or
- were a member of a contracted-out occupational pension scheme.

No SERPS pension was earned for periods of self-employment or unemployment.

In the Social Security Act of 1986 measures were introduced to reduce the value of future SERPS accruals:

- The best 20 years rule was removed and replaced by lifetime revalued band earnings. This was most disadvantageous to those with fluctuating earnings or with an incomplete employment record.

[94] Originally the LEL was not deducted until the year before reaching SPA. Subsequent calculation changes led to the LEL being deducted in the year of accrual. 53 times the weekly UEL is used where an individual has more than one job and is paid by more than one employer at the same time. For someone remaining in the same employment throughout the tax year, the maximum is 52 times the weekly UEL.
[95] Announced in the June 2010 Emergency Budget. webarchive.nationalarchives.gov.uk/20130129110402; www.hm-treasury.gov.uk/junebudget_documents.htm

- The accrual rate was reduced for those reaching SPA after 1998/9 – the long-term target for accrual after 1987/8 was reduced from 25% to 20% of revalued band earnings.

From 1978, members could contract-out of SERPS and into an employer's pension scheme. In addition, from 1988, instead of accruing a SERPS pension, members could contract-out and receive a rebate into a personal pension instead.

The Pensions Act 1995 introduced a further change to the calculation method – the overall effect of which was to reduce entitlement further.

In 2002 SERPS was replaced with State Second Pension (S2P). However, people are still eligible to receive SERPS benefits already accrued. A more detailed discussion about SERPS is available in the Historical Annex.[96]

[96] www.pensionspolicyinstitute.org.uk

Second tier: Contracting-out

Since the introduction of SERPS in 1978 and S2P in 2002 it has been possible for employers to set-up a private pension scheme that is contracted-out of SERPS/S2P.[97] All employees who were members of a private pension scheme could be contracted-out, as long as certain conditions were met. Both the employer and employee would pay lower National Insurance contributions. Each year, instead of accruing a pension within SERPS/S2P the individual would earn benefits within the private pension scheme.

Between 1988 and 2012, individuals who were members of a stakeholder or personal pension were able to contract-out of SERPS/S2P, receiving a rebate into their stakeholder or personal pension plan. The decision was not irrevocable – they could contract-in and out as many times as they wished, for complete tax years. The accumulated fund arising from such rebates is required to be used to provide pension benefits. From April 2006, it was possible to take some of this fund as a tax-free lump-sum.[98]

From April 2012, it is no longer possible to contract-out of S2P for members of Defined Contribution (DC) schemes, stakeholder and personal pensions.[99] People who were previously contracted out into these schemes are now building up rights to the State Second Pension instead. It is still possible for Defined Benefit (DB) schemes to be contracted-out.

The Pensions Act 2004 removed the minimum age (60) from which benefits can be paid, enabling them to be paid at the same age as all other rights (55, though the age was 50 until April 2010). Legislation also removed the requirement that the pension bought must include indexation. Members will still be able to opt for an index-linked pension if they wish. However, pensions that are in payment before the changes came into force in April 2005 will not be affected.

If the individual is married, benefits must now also provide a 50% widow(er)'s pension. The overall aim is for the pension arising from contracting-out to be greater than the SERPS/S2P pension given up.

Sources

Department for Work and Pensions (DWP) (2005) *Annual increases in rates of Pensions*
http://webarchive.nationalarchives.gov.uk/+/http://www.dwp.gov.uk/lifeevent/penret/penreform/7a_indexation.asp
Government Actuary's Department (GAD) (1996) *Occupational and Personal Pension Scheme – Review of Certain Contracting-Out terms*

97 RN Second tier: Contracting-out of S2P
98 RN Third Tier: Options for pension withdrawal
99 Provisions for this were legislated for in the Pensions Act 2007, following the recommendations of the Pensions Commission 2005.

Government Actuary's Department (GAD) (1998) *Occupational and Personal Pension Scheme – Review of Certain Contracting-Out terms*
Government Actuary's Department (GAD) (2001) *Occupational and Personal Pension Scheme – Review of Certain Contracting-Out terms*
www.archive.official-documents.co.uk/document/cm50/5076/5076.pdf
Government Actuary's Department (GAD) (2006) *Occupational and Personal Pension Scheme – Review of Certain Contracting-Out terms*
www.official-documents.gov.uk/document/cm67/6758/6758.pdf

Second tier: Contracting-out – additional elements associated with S2P

The replacement of SERPS with S2P created some additional complications for contracting-out.

Contracting–out into a DB pension scheme
If a Defined Benefit pension scheme is contracted-out then the benefits it provides must meet or exceed a minimum standard. For example, benefits must be structured in such a way that at least 90% of the membership is better off than they would have been if they had remained in SERPS/S2P. The enhancements to S2P would have forced schemes to revise their benefit structures.

At the time of the replacement of SERPS by S2P in 2002, it was decided that contracting-out would continue for both Defined Benefit and Defined Contribution pension schemes on terms similar to those which applied when SERPS was in operation:

- The rebates received by the scheme would be based on the accrual rate under SERPS.
- The individual would also accrue a residual S2P benefit that is calculated as the difference between the S2P accrual and the SERPS accrual.
- So anyone earning below the Upper Earnings Threshold £32,600 (2010/11) would accrue benefits in both their occupational scheme and in S2P. The Upper Earnings Threshold was abolished after 2011 when S2P accrual was reduced to two bands.

Contracting-out into a personal pension
For individuals who were contracted-out into a personal pension, the rebate was based on the individual's actual earnings from employment and the actual S2P accrual rates for the different bands of earnings.

Those earning below the Low Earnings Threshold (LET) accrued S2P benefits within S2P, as the flat rate part of S2P assumed earnings at the LET. The S2P benefit will be based on the difference between their actual earnings and the LET.

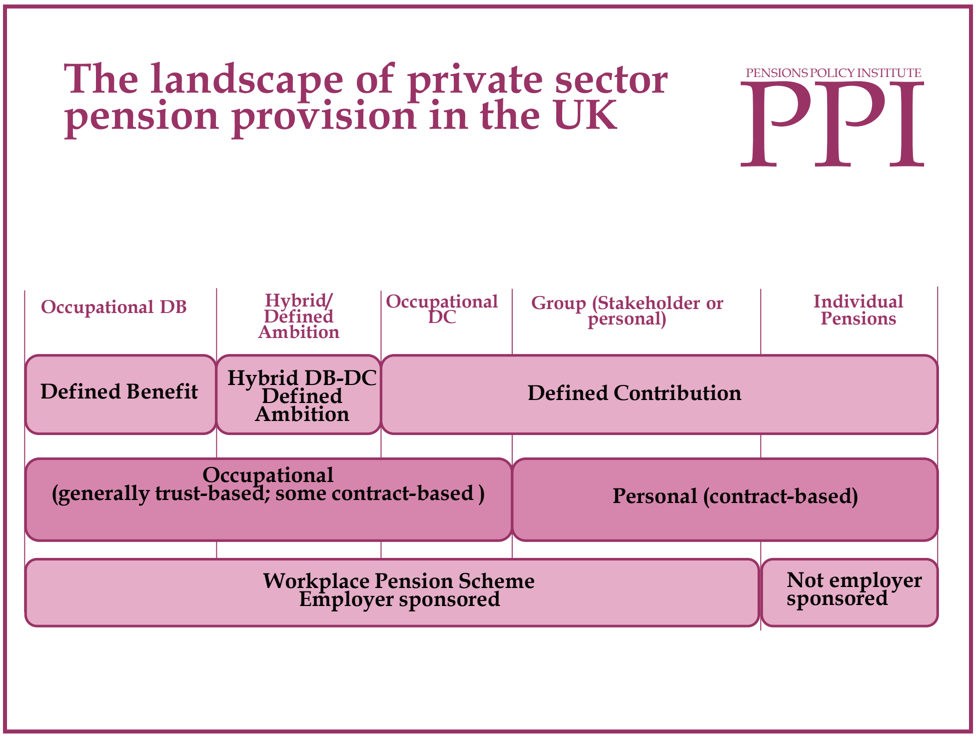
From April 2012 it is no longer possible to contract-out of S2P using a DC occupational, stakeholder or personal pension.

Third tier: Overview of private pension provision

As with state provision, private provision is complicated (Chart 3). The legislative framework has been altered over time, adding layers of new arrangements to those already in place. In addition, because individuals have varied employment histories, many will retire with a number of pensions arising from both employer-sponsored schemes and individual arrangements.

Private pension provision can be made through:
- **Employer-sponsored pension schemes** (including Occupational Pension schemes, group personal pensions, master-trusts and other multi-employer schemes)
- **Individual arrangements**, such as personal pensions (including stakeholder pensions) and before 1988, retirement annuities.[100]

Chart 3[101]



Employer sponsored provision
Some employers run **occupational pension schemes**. Such schemes are arranged under their own trust deeds and rules. The employer usually contributes to these schemes, and more often than not an employee contribution is required. Most schemes are arranged through a single employer, although there are a few industry-wide arrangements.

[100] Access to new retirement annuities contracts ceased in 1988, however those with existing contracts may still contribute.
[101] Adapted from Pensions Commission (2004) *Pensions: Challenges and Choices. The First Report of the Pensions Commission*, Table 3.3, p.80

Occupational schemes can either be **Defined Benefit (DB)** or **Defined Contribution (DC).**

In **Defined Benefit (DB)** schemes, the benefit received upon retirement is determined by a formula which sets the levels of benefits to be offered, and is usually linked to final salary or an average of salary over the length of an individual's period of employment. Contributions are paid into a common fund, which is invested to provide all retirement benefits, except for in some public sector schemes where the pension fund is notional and pensioner benefits are paid out from a combination of current contributions and Government revenue.

The Pensions Act 2004 established the Pension Protection Fund to provide some guarantee of benefits to members of under-funded DB schemes when the sponsoring employer has become insolvent.[102] The Act also introduced a number of changes to the regulatory framework governing Occupational Pension schemes, including the replacement of the Occupational Pensions Regulatory Authority with a new body, the Pensions Regulator.

In some cases DB occupational schemes will be contracted-out, which means the scheme is providing benefits in place of the State Second Pension (S2P).[103] In this case, the employer and employee's National Insurance contributions are reduced or 'rebated' by the government, and this amount is known as the contracted-out rebate. The rebate helps to fund the benefits. Where the scheme is not contracted-out, the individual has the option of contracting-out on an individual basis.

Additional Voluntary Contributions

If individuals in an occupational scheme wish to increase their pension provision further, then they have the option of paying ***additional voluntary contributions*** (AVCs). These AVCs could either be used to purchase extra years of service – at retirement the total pension will be based on earnings and actual service plus any added years purchased – or could be invested and the resultant pension would depend on the accumulated fund and annuity rates applicable at retirement. Since 1987 there has also been the option of ***free-standing AVCs*** (FSAVCs) – these are similar to AVCs except they are a standalone arrangement usually provided by a life assurance company. FSAVCs will only offer money-purchase benefits – they cannot offer added-years. The charges on AVCs are often lower than in other individual arrangements and in some cases the employer will match AVC contributions.

[102] The PPF does not provide support to schemes that belong to employers who became insolvent prior to the establishment of the PPF. To help groups close to retirement who do not fall under the support of the PPF, the Government established the Financial Assistance Scheme (FAS).

[103] RN Second tier: Contracting-out

Defined Contribution (DC) schemes operate on a money-purchase basis. Contributions are paid into individual accounts and the total benefit upon retirement depends on the value of the accumulated fund. After the minimum pension age (currently age 55) people have the option of drawing down their pension in any way they wish subject to their marginal tax rate. 25% of their pot can be taken tax-free.

Personal Pensions

Since 1988, it has been possible for employers to make contributions to an employee's **personal pension**. Contributions could be solely from the employer or from both the employee and the employer. Employers can also arrange a **group personal pension (GPP)**. In GPP's, each individual member has their own plan but charges have typically been lower than in individual personal pensions, at least while the member remained in that employment, reflecting the group nature of the contract. However, the introduction of the charge cap for default funds in automatic enrolment qualifying schemes may reduce some of the differences between scheme charges.

Stakeholder pensions were introduced in 2001 as a form of DC personal pension that was required to meet a number of Government standards. The main difference between these and other types of personal pensions at the time was that management charges in each year were limited by a maximum charge cap and providers were not permitted to charge exit penalties.[104] For people who joined a stakeholder pension after 6 April 2005, the maximum fund management charge was 1.5% for the first 10 years, thereafter reducing to 1%. For stakeholder plans that were opened before this date, the previous maximum charge of 1% continued to apply. However, subsequent legislation has removed most of the differences between stakeholder pension schemes and other pension schemes used for automatic enrolment. Schemes used for automatic enrolment can now not charge more than 0.75% total Annual Management Charges, excluding transaction costs.

Though employers are no longer required to provide access to Stakeholder schemes as they were under previous legislation, they are still available for use alongside other personal pensions. Automatic enrolment has also heralded the rise of multi-employer schemes, some of which are master-trusts.

Multi-employer schemes are schemes that offer the same terms to every member regardless of whether they join the scheme as part of a group via their employer or singly as an employee or as a self-employed person. Some of these schemes are Defined Contribution Schemes run by an insurance company or pension provider. Others are **master trusts**, which

[104] RN Third tier: Individual pension arrangements

are Defined Contribution schemes governed by a board of trustees who owe a fiduciary duty to members.

These include a national pension saving scheme of low-cost, individualised pension savings accounts legislated for in the Pensions Act 2008 called **NEST (National Employment Savings Trust)**. Employers who do not offer an occupational pension or a stakeholder or other qualifying pension scheme will be able to auto-enrol their employees into NEST, provided that the employee's earnings are above the current automatic enrolment threshold for 2015/16 of £10,000. Employees with earnings below this level will be permitted to opt in to the scheme.

NEST has a low-charging structure. Members are charged an Annual Management Charge of 0.3% of the fund per year. However, until the start-up costs of the scheme are recovered, NEST members will also pay a 1.8% charge on contributions.[105]

There are currently restrictions on the amount of contributions that can be made into NEST - £4,700 a year in 2015/16)[106] - and on individuals transferring pension funds into and out of NEST, (except for annuity purchase, where a pension is shared through a divorce settlement or where an individual has been in an occupational pension scheme for less than two years). Following a call for evidence on these restrictions,[107] the Government has announced that the annual contributions limit will be lifted from April 2017, and that the restrictions on individual transfers will be removed in line with the introduction of automatic transfers. There is no intention to lift any restrictions on bulk transfers.[108]

NEST is not the only option for employers without their own pension. Other pension scheme master trusts have been set up in the private sector, which aim to provide a pension scheme eligible for automatic enrolment. These include Now Pensions and The People's Pension.

Since April 2012, it is no longer possible to contract-out from S2P for members of Defined Contribution (DC) schemes.[109] People who were

[105] See NEST (2012) *Low charges for future members of NEST.* www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/low-charges-for-future-members-of-NEST,PDF.pdf

[106] Equivalent to £3,600 in 2005/2006 earnings terms. Johnson, P. Yeandle, D. Boulding, A. (2010) *Making automatic enrolment work: A review for the Department for Work and Pensions*, p.19 www.gov.uk/government/uploads/system/uploads/attachment_data/file/214585/cp-oct10-full-document.pdf

[107] DWP (2012) *Supporting automatic enrolment www.gov.uk/government/uploads/system/uploads/attachment_data/file/220474/nest-automatic-enrolment-call-for-evidence.pdf*

[108] DWP (2013) Supporting automatic enrolment The Government response to the call for evidence on the impact of the annual contribution limit and the transfer restrictions on NEST: www.gov.uk/government/uploads/system/uploads/attachment_data/file/211063/nest-automatic-enrolment-call-for-evidence-response.pdf

[109] Provisions for this were legislated for in the Pensions Act 2007, following the recommendations of the Pensions Commission 2005.

previously contracted-out in DC schemes are now building up rights to the State Second Pension. It is still possible to contract-out from S2P for members of occupational DB schemes.

Defined ambition, shared risk and collective benefit schemes
The Pension Schemes Act 2015 introduced legislation to facilitate the development of shared risk and collective benefit schemes in the UK. The Act defines three different categories of pension scheme based on the type of promise offered to members during the accumulation phase about the level or amount of pension benefits. This promise will either refer to all of the retirement income payable from the scheme (Defined Benefit), some of the retirement income or some or all of the pot (shared risk), or no promise (Defined Contribution). Some forms of risk-sharing schemes already existed for example, hybrid schemes (e.g., cash-balance schemes, or with-profit arrangements or 'nursery schemes' that work like a DC scheme for younger staff, but become related to final salary as the member gets older.

The Act also includes measures to enable the provision of collective benefits using **Collective Defined Contribution** (CDC) schemes. These schemes are enabled for in the Act through legislation allowing for scheme assets to be used in a way that pools risks across the scheme membership, by creating a single collective fund rather than individual funds (as in individual Defined Contribution.) The legislation allows for the development of new structures offering collective benefits that allow for the pooling of investment, inflation and longevity risks between members within a workplace pension structure, and allows for pensions in payment to fluctuate.

Charge cap
The Occupational Pension Schemes (Charges and Governance) Regulations 2015 introduced a cap on the charges of default funds used for automatic enrolment. This cap limits the total annual cost to members whose funds are invested in the default fund to 0.75% of funds under management. The cap applies to all scheme and investment administration charges. Transaction costs (third-party costs generated when investments are sold and bought on the market) are excluded from the charge cap.[110]

Options for pension withdrawal; minimum pension age
In April 2010 the minimum age at which private pensions could be taken was increased from age 50 to 55. However, in the Budget 2014 it was announced that this would rise to 57 in 2028. It is possible to begin withdrawing a pension, once over the minimum pension age, whilst still working.

[110] www.gov.uk/government/uploads/system/uploads/attachment_data/file/420215/charge-cap-guidance-apr-2015.pdf

Prior to April 2006, upon reaching retirement age individuals could take a 25% tax-free lump sum leaving the rest invested in an income drawdown account, within limits. By age 75, any remaining pension pot balance had to be annuitised. Individuals with a pension pot below the trivial commutation limit were allowed to take the whole fund as a lump-sum.

Between 2006 and 2010, if a person had private pension savings above the trivial commutation limit and had not opted for an annuity by the time they reached age 75 they were required to begin withdrawing their pension benefits, either by purchasing an annuity or by the additional option of an alternatively secured pension (ASP), which was primarily designed for those who had a principled religious objection to buying an annuity, but was used by some people as a way to avoid purchasing an annuity over age 75.

From April 2011, the requirement to purchase an annuity by age 75 was removed. Between April 2011 and April 2015, when individuals withdrew DC pension saving, they could choose from one or a combination of four options:

- Taking a 25% tax-free cash lump sum (subject to scheme rules). If an individual's entire pension fund was less than the trivial commutation limit (set at £30,000 from 27 March 2014),[111] it was possible to 'trivially commute' and take the whole fund as a lump sum, with 25% being tax-free and the remainder taxed at their marginal rate.
- Investing some or all of their fund for some part or all of their retirement in an income drawdown account (while taking an income from it, capped at 150% of an equivalent annuity);
- Purchasing an annuity. An insurance product that pays an income from the date of purchase until the date of death.[112]
- Withdrawing their fund in unlimited amounts provided that individuals can demonstrate a secured guaranteed lifetime pension income of at least £20,000 per year.[113]

People can now access DC pension savings flexibly from age 55

The Government announced in the 2014 Budget that, from 6 April 2015, individuals will be able to flexibly access DC pension savings from age 55. This means that at age 55, people can still take a 25% tax-free lump sum if they wish to (subject to scheme rules) however they are not required to purchase a retirement income product in order to access their pension savings. The options open to people with DC savings are limited only to the products available and the amount of savings people have. They are also governed by taxation.

[111] The trivial commutation has previously been set at 1% of the Lifetime Allowance (currently £1.8m) however it has been decoupled from the lifetime allowance from 2012 HMT (2010) *Restricting pensions tax relief through existing allowances: a summary of the discussion document responses*, p. 26.
[112] An annuity insures against an individual's money running out because he or she lives longer than expected
[113] HMT (2011). *Removing the Effective Requirement to Annuitise by Age 75*, p.2. webarchive.nationalarchives.gov.uk/20130129110402; www.hm-treasury.gov.uk/d/pensions_annuitisation.pdf

Those with DB pension savings may not use flexible access unless they transfer their DB entitlement into a DC scheme first. Some public sector DB schemes do not allow transfers.

People with DC savings may, at age 55, do one or a combination of the following, (though this list is not exhaustive as the retirement income market is still evolving in light of the new policy):

- Leave their pension fund invested and withdraw in unlimited amounts, taxed at an individual's marginal rate.
- Purchase a retirement income product including a lifetime annuity, a fixed-term or deferred annuity or income drawdown, without a cap on withdrawal amounts.
- A product such as longevity insurance.

Automatic enrolment into pension schemes from 2012

The previous Labour Government acted on the recommendations of the Pensions Commission (who reported in 2005)[114] and legislated in the Pensions Act 2008 for the introduction of automatic enrolment into private pensions. Automatic enrolment began "staging" in October 2012. Qualifying employees between age 22 and State Pension Age are eligible for automatic enrolment into a scheme chosen by the employer, with employees having the right to opt-out. The earnings threshold above which every employee should be auto-enrolled is £10,000 in 2014/15 and 2015/16. Contributions become payable on band earnings over £5,824 and up to a limit of £42,385 (2015/16).[115]

After a phasing-in process of 6 years, minimum total contributions of 8% of earnings within designated bands will be paid to a qualifying pension scheme, with a minimum of 3% from the employer. Employees can also contribute and the Government will contribute through tax relief. The specific employee contribution rate will depend on the employer contribution. The Government contribution will be proportional to the employee contribution, as it is calculated as tax relief on employee contribution. If the employer decides to contribute the legal minimum of 3% of band earnings, then the employee who does not opt out will have to contribute 4% and the Government will contribute around 1% through tax relief. [116] However, employers will decide whether they want to contribute the legal minimum or more.

Tax Simplification

The Finance Act 2004, which took effect from 6 April 2006, included a number of amendments designed to simplify the taxation of the UK private pension regime, effectively capturing all pensions under a single

[114] Pensions Commission (2005) *A New Pension Settlement for the Twenty-First Century*, p.
[115] www.thepensionsregulator.gov.uk/employers/automatic-enrolment-earnings-threshold.aspx
[116] The tax relief may be higher for those people who pay higher-rate tax

set of rules.[117] Compared to the pre-April 2006 system, there is no limit on the amount of pension saving that an individual can build up in a registered pension scheme.[118] Instead, the amount by which an individual can benefit from tax advantages is controlled by two 'allowances': annual and lifetime. These allowances apply to each individual, and across all registered pension schemes that the individual uses for providing benefits, regardless of the time of joining.[119]

An individual can make contributions to any number of private pension schemes and receive tax relief on the amount saved in that year. If in any year the contributions paid by and for the member to money purchase type arrangements, plus the increase in value of benefits under Defined Benefit type arrangements, are more than the annual allowance (AA) (for the tax year 2015/16 this is £40,000), the excess will be taxed at the rate of 40%. The tax charge is payable by the individual.

Individuals who do not pay tax can still receive tax relief at the basic rate (20%) on all contributions to a private pension in one year up to a limit of £3,600.

The lifetime allowance (LTA) regulates the amount of tax relief an individual is entitled to on their pension savings over a lifetime. Any pension savings in excess of the LTA, set at £1.25 million in 2015/16, will be taxed at the LTA charge of 25% if the benefits are taken as a pension, or 55% if taken as a lump sum. The Lifetime Allowance will be reduced to £1 million in April 2016.[120]

[117] Inland Revenue (IR) (2003) *Simplifying the taxation of pension: the Government's Proposals* and Her Majesty's Treasury (HMT) (2004) *Prudence for a purpose: A Britain of stability and strength*, Budget report webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/budget/budget_04/bud_bud04_index.cfm

[118] All pension schemes must be registered with the HM Revenue and Customs in order to qualify for tax relief and exemption from various taxes

[119] Although exemptions to the lifetime allowance are available to protect existing rights

[120] www.gov.uk/government/publications/budget-2015-hm-revenue-and-customs-overview/hmrc-overview#savings-personal-tax-national-insurance-and-pensions

Third tier: Employer-sponsored pension provision

There are a number of different options available to employers who wish to provide pension arrangements for their employees.

Defined Benefit (DB) occupational pension schemes
There are two main types of DB schemes: 'final salary' and career average.

The benefit arising from a final salary pension scheme is based on an individual's earnings at, or close to, leaving the scheme and their length of service. Career average schemes offer a benefit based on average salary over the course of scheme membership, revalued to take account of inflation throughout the individual's time within the scheme.

Benefits are usually expressed in terms of pension – but the individual has the option of taking a reduced pension and receiving a tax-free lump sum instead. A scheme might typically promise a pension of $1/60^{th}$ or $1/80^{th}$ of final salary for each year of service, or alternatively a combined benefit of $1/80^{th}$ pension plus $3/80^{ths}$ lump sum for each year of service (although the amount of lump sum may be capped to be within the Revenue's limit for tax-free cash payments).

The scheme will have a specified retirement age – usually 60 or 65. A member can usually take benefits early but is likely to incur a reduction in the accrued benefits to compensate for the longer time that benefits are payable.

Defined Contribution (DC) occupational pension schemes
With a DC or 'money purchase' scheme the employer will specify a rate of contribution, usually expressed as a percentage of salary or total earnings that they will contribute on behalf of a member. The rate of contribution could be flat rate or could increase with age and/or length of service and/or seniority and/or level of earnings. In addition there might be an element of matching - the employer makes a base level of contribution on behalf of all employees and will increase this where the employee also makes a contribution.

The contributions are invested. Often there is a choice of investment funds – managed, equity, property, gilts, and overseas – and with some schemes a choice of investment manager.

At retirement the pension will depend on the accumulated fund, the amount deducted from the fund as a tax-free lump sum (which is usually up to 25% of the total fund) and the method of accessing savings. The employer makes no guarantees regarding the level of benefits that the accumulated fund will provide – if investment returns or retirement income product rates are poor, then the resultant pension will be lower, whereas conversely if they are better, then the pension will be higher.

Defined ambition, shared risk and collective benefit schemes
The Pension Schemes Act 2015 introduced legislation to facilitate the development of shared risk and collective benefit schemes in the UK. The Act defines three different categories of pension scheme based on the type of promise offered to members during the accumulation phase about the level or amount of pension benefits. This promise will either refer to all of the retirement income payable from the scheme (Defined Benefit), some of the retirement income or some or all of the pot (shared risk), or no promise (Defined Contribution). Some forms of risk-sharing schemes already existed for example, hybrid schemes. Hybrid pension schemes are a catch-all term for schemes that combine elements of DB and DC schemes. This can be done in a number of ways, and is often used as a means for employers to share investment and mortality risk with employees and to increase scheme flexibility.

Such schemes provide a mix of benefits. For example, a 'nursery scheme' works like a DC scheme for younger staff, but becomes related to final salary as the member gets older. Alternatives include DC schemes which guarantee that pension benefits will not fall below the level of a final salary scheme and DB schemes which cap the salary used when calculating the final benefit, incorporating a DC top-up for members who earn more than this.

The Pension Schemes Act 2015 also includes measures to enable the provision of collective benefits using **Collective Defined Contribution** (CDC) schemes. These schemes are enabled for in the Act through legislation allowing for scheme assets to be used in a way that pools risks across the scheme membership, by creating a single collective fund rather than individual funds (as in individual Defined Contribution.) The legislation allows for the development of new structures offering collective benefits that allow for the pooling of investment, inflation and longevity risks between members within a workplace pension structure, and allows for pensions in payment to fluctuate.

Group personal pensions (GPP) and group stakeholder pensions
Some employers have introduced a GPP scheme, or more recently a group stakeholder pension. This is in effect a series of individual personal pensions. These schemes are handled by a pension provider at the request of an employer. The main advantage of a GPP compared to an individual arrangement is that charges are likely to be lower. In addition, prior to automatic enrolment, employers were more likely to be making an employer contribution into a GPP than a personal pension.

From April 2001 all employers with 5 or more employees were required to designate a stakeholder provider to which they would make payments deducted from an employees pay if they requested. Employers were not required to make any contributions prior to their automatic enrolment staging dates.

The main difference between these and other types of personal pensions at the time was that management charges in each year were limited by a maximum charge cap and providers were not permitted to charge exit penalties. However, the introduction of the charge cap for default funds in automatic enrolment qualifying schemes may reduce some of the differences between scheme charges.

Though employers are no longer required to provide access to Stakeholder schemes as they were under previous legislation, they are still available for use alongside other personal pensions. Automatic enrolment has also heralded the rise of multi-employer schemes, some of which are master-trusts.

Multi-employer schemes are schemes that offer the same terms to every member regardless of whether they join the scheme as part of a group via their employer or singly as an employee or as a self-employed person. Some of these schemes are Defined Contribution Schemes run by an insurance company or pension provider. Others are **master trusts**, which are Defined Contribution schemes governed by a board of trustees who owe a fiduciary duty to members.

These include a national pension saving scheme of low-cost, individualised pension savings accounts legislated for in the Pensions Act 2008 called **NEST (National Employment Savings Trust)**. Employers who do not offer an occupational pension or a stakeholder or other qualifying pension scheme will be able to auto-enrol their employees into NEST, provided that the employee's earnings are above the current automatic enrolment threshold for 2015/16 of £10,000. Employees with earnings below this level will be permitted to opt in to the scheme.

NEST has a low-charging structure. Members are charged an Annual Management Charge of 0.3% of the fund per year. However, until the start-up costs of the scheme are recovered, NEST members will also pay a 1.8% charge on contributions.[121]

There are currently restrictions on the amount of contributions that can be made into NEST - £4,700 a year in 2015/16)[122] - and on individuals transferring pension funds into and out of NEST, (except for annuity purchase, where a pension is shared through a divorce settlement or where an individual has been in an occupational pension scheme for less

[121] See NEST (2012) *Low charges for future members of NEST.* www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/low-charges-for-future-members-of-NEST,PDF.pdf

[122] Equivalent to £3,600 in 2005/2006 earnings terms. Johnson, P. Yeandle, D. Boulding, A. (2010) *Making automatic enrolment work: A review for the Department for Work and Pensions*, p.19 www.gov.uk/government/uploads/system/uploads/attachment_data/file/214585/cp-oct10-full-document.pdf

than two years). Following a call for evidence on these restrictions,[123] the Government has announced that the annual contributions limit will be lifted from April 2017, and that the restrictions on individual transfers will be removed in line with the introduction of automatic transfers. There is no intention to lift any restrictions on bulk transfers.[124]

NEST is not the only option for employers without their own pension. Other pension scheme master trusts have been set up in the private sector, which aim to provide a pension scheme eligible for automatic enrolment. These include Now Pensions and The People's Pension.

Automatic enrolment into pension schemes from 2012

The previous Labour Government acted on the recommendations of the Pensions Commission (who reported in 2005)[125] and legislated in the Pensions Act 2008 for the introduction of automatic enrolment into private pensions. Automatic enrolment began "staging" in October 2012. Qualifying employees between age 22 and State Pension Age are eligible for automatic enrolment into a scheme chosen by the employer, with employees having the right to opt-out. The earnings threshold above which every employee should be auto-enrolled is £10,000 in 2014/15 and 2015/16. Contributions become payable on band earnings over £5,824 and up to a limit of £42,385 (2015/16).[126]

Staging and phasing of automatic enrolment

Automatic enrolment started in October 2012 with large employers enrolling their eligible employees in a staged process.

Large employers with 250 or more employees were required to automatically enrol their eligible employees from 1 October 2012 to 1 February 2014.

Medium sized employers with 50 to 249 employees had automatic enrolment dates between 1 April 2014 and 1 April 2015.

Small employers with less than 50 employees have automatic enrolment staging dates between 1 June 2015 and 1 April 2017.

New employers setting up business from 1 April 2012 and up to and including 30 September 2017 will have automatic enrolment dates between, and including, 1 May 2017 and 1 February 2018. All employers will be required to automatically enrol eligible employees from 1

[123] DWP (2012) *Supporting automatic enrolment* *www.gov.uk/government/uploads/system/uploads/attachment_data/file/220474/nest-automatic-enrolment-call-for-evidence.pdf*
[124] DWP (2013) Supporting automatic enrolment The Government response to the call for evidence on the impact of the annual contribution limit and the transfer restrictions on NEST: www.gov.uk/government/uploads/system/uploads/attachment_data/file/211063/nest-automatic-enrolment-call-for-evidence-response.pdf
[125] Pensions Commission (2005) *A New Pension Settlement for the Twenty-First Century*, p.
[126] www.thepensionsregulator.gov.uk/employers/automatic-enrolment-earnings-threshold.aspx

February 2018. Any new employer setting up business from 1 October 2017 onwards will be required to comply immediately if paying earnings which attract PAYE deductions in respect of any worker.

The specific employee contribution rate will depend on the employer contribution. The Government contribution will be proportional to the employee contribution, as it is calculated as tax relief on employee contribution. If the employer decides to contribute the legal minimum of 3% of band earnings, then the employee will have to contribute 4% and the Government will contribute 1% through tax relief.[127] However, employers will decide whether they want to contribute the legal minimum or more. Minimum employer contributions will be phased-in starting at a minimum 1% of band earnings in October 2012. The increase in minimum employer contributions from 1% to 2% will begin on 1 October 2017. Contributions will then increase to 3% from 1 October 2018.

Automatic enrolment test

With the introduction of automatic enrolment and NEST in 2012, the Government has set an exemption test for deciding whether an employer-based pension scheme is of a high enough standard to allow the employer to be exempt from auto-enrolling eligible employees into NEST.[128] In order to qualify as an automatic enrolment scheme, a pension scheme must:

- Allow contributions to be made by the employer,
- Be "registered", this means the type of scheme that receives tax advantages under the Finance Act 2004,
- Defined Contribution schemes must have employer contributions of at least 3%, and total contributions of at least 8%, of qualifying earnings,
- Defined Benefit schemes must be contracted out, or satisfy the Test Scheme standard for all active members,[129]
- Hybrid schemes must satisfy either the money purchase requirement or the Defined Benefit requirement as appropriate according to rules set out by the Secretary of State.

[127] The tax relief may be higher for those people who pay higher-rate tax

[128] This was implemented as a consequence of the provisions legislated in the Pensions Act 2008 related to the introduction of automatic enrolment into private pensions and the rolling out of NEST from October 2012.

[129] Test Scheme is a scheme that provides a pension from age 65 of 1/120 x average qualifying service over the last 3 tax years before retirement for each year of qualifying service.

Third tier: Individual pension arrangements

From 1956 individual pension arrangements were available in the form of retirement annuities. These were then replaced in 1988 with personal pensions. Even though a new retirement annuity contract cannot be bought, regular contributions can still be made to existing contracts. The level of contribution to these contracts may also be changed.

Prior to 2001, personal pensions were only available to individuals while they were self-employed, or were not members of an Occupational Pension scheme. In April 2001, stakeholder pensions were introduced which widened access further,[130] and from April 2006, individual pension arrangements have been open to everyone under age 75.

Stakeholder pensions are a form of personal pension introduced in 2001 that were required to meet a number of Government standards. The main difference between these and other types of personal pension when they were introduced was that a maximum charge cap limited management charges in each year.

For people who joined a stakeholder pension after 6 April 2005, the maximum annual fund management charge was 1.5% for the first 10 years, thereafter reducing to 1%. For stakeholder plans that were opened before this date, a maximum charge of 1% was applied. However, subsequent legislation has removed most of the differences between stakeholder pension schemes and other pension schemes used for automatic enrolment.

The majority of individual pension arrangements are now subject to the charge cap, which limits the total annual cost to members whose funds are invested in the default fund to 0.75% of funds under management. The cap applies to all scheme and investment administration charges. Transaction costs (third-party costs generated when investments are sold and bought on the market) are excluded from the charge cap.[131]

Individual pension arrangements are in the form of a money-purchase arrangement - i.e. the contributions, from the individual member or, when applicable, an employer will be invested and the accumulated fund will

[130] Between April 2001 and April 2006 members of an occupational pension scheme earning less than £30,000 per annum had an alternative 'concurrency' option. This allowed them to contribute up to £3,600 per annum into a stakeholder or personal pension. The £30,000 limit applied to each employment. So for example, it was possible for someone with more than one employment to have a concurrent pension even if his or her total earnings were above £30,000.
[131] www.gov.uk/government/uploads/system/uploads/attachment_data/file/420215/charge-cap-guidance-apr-2015.pdf

provide a lump sum, which can be withdrawn or re-invested in a retirement income product.[132]

Contributions to personal pension schemes are subject to the lifetime and annual allowances.[133]

[132] Prior to 6 April 2006, the tax-free lump sum was limited to 25% of the accumulated fund for personal and stakeholder pensions, whereas for retirement annuities it depended on the annuity rates available at retirement and varied between 18% and 30%

[133] RN on Tax treatment of private pension provision

Third tier: Options for pension withdrawal

With both state pensions and Defined Benefit Occupational Pension schemes there is some degree of certainty about the level of income an individual will receive once pension payments commence.

In comparison, the actual level of income from a Defined Contribution occupational scheme or personal pension arrangement cannot be predicted in advance. The level of pension provided will depend on the method of access, on market conditions and, in some cases, may not constitute a "pension" but rather a series of flexible withdrawals as and when desired by the fund holder.

Contributions are invested and used to build up a pension fund on behalf of the individual. The ultimate size of this fund will vary, depending on a number of factors including:

- Level of contributions.
- Number of contributions.
- Timing of contributions.
- Underlying investment returns – which in turn depend on the choice of fund manager, the choice of underlying investments – for instance managed, equity, property, gilts, overseas equity, cash – and investment performance until the date the fund is actually cashed.
- Charges levied against the fund.

The Finance Act 2004 raised the minimum age at which people can withdraw their pension benefits from age 50 to age 55 from April 6 2010. It also introduced the option of more flexible retirement – people can continue working whilst taking pension benefits – where occupational pension scheme rules allow it. However, in the Budget 2014 it was announced that this will rise to 57 in 2028.

Prior to April 2006, upon reaching retirement age individuals could take a 25% tax-free lump sum leaving the rest invested in an income drawdown account, within limits. By age 75, any remaining pension pot balance had to be annuitised. Individuals with a pension pot below the trivial commutation limit were allowed to take the whole fund as a lump-sum.

Between 2006 and 2010, if a person had private pension savings above the trivial commutation limit and had not opted for an annuity by the time they reached age 75 they were required to begin withdrawing their pension benefits, either by purchasing an annuity or by the additional option of an alternatively secured pension (ASP), primarily for those who had a principled religious objection to buying an annuity, but was used by some people as a way to avoid purchasing an annuity over age 75.

From April 2011, the requirement to purchase an annuity by age 75 was removed. Between April 2011 and 6 April 2015 people over the age of 55 could choose one or a combination of following options:

- Taking a 25% tax-free cash lump sum (provided the scheme rules allowed it). If an individual's entire pension fund was less than the trivial commutation limit (set at £30,000 from 27 March 2014),[134] it was possible to 'trivially commute' and take the whole fund as a lump sum, with 25% being tax-free and the remainder taxed at their marginal rate.
- Investing some or all of their fund for some part or all of their retirement in an income drawdown account (while taking an income from it, capped at 150% of an equivalent annuity);
- Purchasing an annuity. An insurance product that pays an income from the date of purchase until the date of death.[135]
- Withdrawing their fund in unlimited amounts provided that individuals can demonstrate a secured guaranteed lifetime pension income of at least £20,000 per year.[136]

People can now access DC pension savings flexibly from age 55
The Government announced in the 2014 Budget that, from 6 April 2015, individuals will be able to flexibly access DC pension savings from age 55. This means that at age 55, people can still take a 25% tax-free lump sum if they wish to (and if scheme rules allow) however they are not required to do so in order to access their pension savings. The options open to people with DC savings are limited only to the products available and the amount of savings people have. They are also governed by taxation.

Those with DB pension savings may not use flexible access unless they transfer their DB entitlement into a DC scheme first. Some DB schemes in the public sector do not allow transfers.

People with DC savings may, at age 55, do one or a combination of the following, (though this list is not exhaustive as the retirement income market is still evolving in light of the new policy):

- Leave their pension fund invested and withdraw in unlimited amounts, taxed at an individual's marginal rate.
- Purchase a retirement income product including a lifetime annuity, a fixed-term or deferred annuity or income drawdown, without a cap on withdrawal amounts.
- A product such as longevity insurance.

[134] The trivial commutation has previously been set at 1% of the Lifetime Allowance (currently £1.8m) however it has been decoupled from the lifetime allowance from 2012 HMT (2010) *Restricting pensions tax relief through existing allowances: a summary of the discussion document responses*, p. 26.
[135] An annuity insures against an individual's money running out because he or she lives longer than expected
[136] HMT (2011). *Removing the Effective Requirement to Annuitise by Age 75,* p.2.
webarchive.nationalarchives.gov.uk/20130129110402; www.hm-treasury.gov.uk/d/pensions_annuitisation.pdf

Annuities

Many people who retired with DC pension savings prior to April 2015 purchased an annuity and therefore they still constitute a significant proportion of income for current pensioners. Most annuities purchased prior to April 2015 were level; meaning that once the annuity is purchased, the level of income an individual receives from it is then set for the remainder of the individual's life.

The cost of an annuity depends on the following factors:

- Long-term interest rates prevalent in the market at that time
- The age and gender of the individual
- The health and lifestyle of the individual - for example those in poor health may be able to get a higher income from their fund
- The type of benefits chosen – for example those increasing in line with RPI, or incorporating a spouse's pension are more expensive
- Expenses of the provider, including any profit margins.

While people are no longer compelled to purchase an annuity in order to access their DC savings, there are still many annuities on the market including lifetime annuities, fixed-term annuities which provide an income for a set period, enhanced or impaired-life annuities which pay out a higher rate to individuals who may have a lower life expectancy due to health or lifestyle factors.

Some annuities are investment-linked, where the payments are linked to the value of the underlying assets. The income, as with all pension income, is taxable as earned income.

Selling annuities to third-parties

In March 2015 the Government announced that, from 2016, it would remove the tax restrictions preventing people from selling their annuities on to a third-party. In effect this means that people will be allowed to sell their annuities to a third-party in return for a lump sum. The third-party would then receive any further annuity payments until the death of the original annuitant. The Government is currently consulting on how this policy will work in practice, though they have already determined that people will not be able to sell their annuities back to their original provider as this may create financial problems for annuity providers and might lead to people believe that they can only sell their annuities to their original provider, therefore removing the element of competition.[137]

[137]www.gov.uk/government/uploads/system/uploads/attachment_data/file/413764/Creating_a_secondary_annuity_market__web_file_.pdf

Third tier: The Pension Protection Fund

A key feature of Defined Benefit schemes is that the employer is assumed to pay sufficient contributions to ensure that the promised benefits are paid. However, in some cases employers are not able to pay the promised benefits if, for example, their scheme becomes underfunded or the employer becomes insolvent.

The Pensions Act 2004 established a **Financial Assistance Scheme (FAS)** to offer help to members who have lost benefits through Occupational Pension schemes that are underfunded when they begin to wind up and/or where the employer is insolvent or no longer exists.[138] Members from under-funded pension schemes that started winding up between 1 January 1997 and 5 April 2005 are potentially eligible for help from the FAS.[139]

The **Pension Protection Fund (PPF)** became operational in April 2005.[140] It has been designed to protect members of certain eligible Defined Benefit occupational schemes and the DB parts of hybrid schemes. The PPF aims to pay some of the pension to members of schemes who lose out when the employer running their scheme becomes insolvent and the pension fund is underfunded.

The PPF is managed by an independent Board, who pay compensation, calculate annual levies and oversee the investment of the fund assets.

The PPF pays out 100% of the current level of pensions already in payment, and 90% of the pension owed for people not yet receiving a pension. Pensions in payment are increased each year in line with the rise in the Consumer Prices Index (CPI) capped at 2.5%. Compensation payments are subject to an overall cap. The standard amount of the cap is age related, for example, from April 2015 the standard amount of the cap at age 65 is £36,401.19 for current pensioners (£32,761 for a 65-year-old not yet receiving a pension), and is adjusted depending on the age that the pension comes into payment.[141] These factors may mean that pensions

[138] DWP Pension Reform – Financial Assistance Scheme www.dwp.gov.uk/lifeevent/penret/penreform/fas/
[139] Extensions to FAS were announced in December 2007. The Pensions Act 2007 provides part of those extensions and the rest will be brought forward in regulations. The changes raise the rate of assistance to 90% of accrued pension at the date of commencement of wind up, revalued to their retirement date. This will be subject to a cap of £26,000 per annum. Assistance will be paid from the scheme's normal retirement age (but not before age 60). To be eligible to get payments from FAS a person needs to be or have been a member of a qualifying pension scheme (or the survivor of such a member). The extensions to FAS remove the age criterion for eligibility. Members of qualifying schemes no longer need to have been within 15 years of their normal retirement age on or before 14 May 2004 to qualify for assistance; the new, more generous level of assistance will be received by all qualifying members, regardless of age. Schemes belonging to solvent employers may now also be eligible.
webarchive.nationalarchives.gov.uk/+; www.dwp.gov.uk/lifeevent/penret/penreform/fas/pensions-hoc-statement-17-12-07.pdf
[140] www.pensionprotectionfund.org.uk for further information on the PPF
[141]www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/Compensation_cap_factors_Apr_2014.pdf

received from the PPF are smaller than some members had expected to receive from their original scheme.

Increased compensation cap for long service
In June 2013 the Pensions Minister announced that the compensation cap would be increased for employees with long service. For each year of service over 20 years the cap would be uprated by 3% of the standard amount for a person of their retirement age. The enhanced cap is subject to a maximum of twice the standard amount. These new rules would apply to existing and future beneficiaries from the PPF. Compensation would be reassessed for people currently receiving pension payments from the PPF but would not be backdated. These measures have been included in the Pensions Act 2014.[142]

Compensation payments are partly funded by compulsory annual levies contributed by eligible schemes. Since 2006/7, the annual levy comprises an administration levy and a pension protection levy. The administration levy is set in statute and covers the PPF's initial start-up and running costs. The pension protection levy is set by the PPF Board based on scheme and risk-based factors. Scheme-based factors take into account the level of liability owed to the scheme's members. The risk-based element relates to a scheme's funding level and the risk of becoming insolvent. When the PPF takes responsibility for a scheme, it will also acquire the remaining assets of that scheme to help pay for member's compensation.

[142] *Pensions Act 2014* www.legislation.gov.uk/ukpga/2014/19/contents/enacted

Third tier: Pension fund regulatory framework

The Pensions Act 2004 introduced a number of changes to the regulation of Occupational Pension schemes.[143]

This included the introduction of The Pensions Regulator who replaced the Occupational Pensions Regulatory Authority in April 2005. This independent body aims to protect members of work-based private pension schemes, to promote good scheme administration practices and to reduce the likelihood of members having to claim compensation from the Pension Protection Fund.[144]

The Regulator has new powers to tackle under-funding and will focus its investigative powers on schemes that are at risk from fraud or poor management and administration.

A second aim of the Pensions Regulator is to reduce the burden of regulation compliance on well-run schemes, in order to allow them more flexibility.

Most occupational pension schemes are established as trusts, so the pension scheme's assets are managed separately from the sponsoring employer's control. A trustee is a person or company who is responsible for running the pension scheme properly and securing members' benefits.

The role and duties of trustees are set by various laws and acts of Parliament supported by guidance from the Pensions Regulator.[145]

In addition, the Pensions Act 2004 introduced new regulations on the management and governance of pension schemes.

There are two main requirements:
- For at least a third of trustees in every scheme to be nominated and selected by members.
- Obligations of trustees to have knowledge of scheme documentation, pensions and trust law and principles of investing and funding.

One of the responsibilities of trustees is to ensure that their schemes are adequately funded. The Pensions Act 2004 replaced the minimum funding requirement (MFR) with more scheme specific requirements. Additional legislation includes:
- Trustees to publish a Statement of Funding Principles, setting out funding strategies and strategies to tackle funding deficits.

[143] Outlined in DWP (2003) Simplicity, security and choice: Working and saving for retirement action on occupational pensions
[144] www.thepensionsregulator.gov.uk
[145] Trustees and the Pensions Regulator www.thepensionsregulator.gov.uk/trustees/

- Better information for scheme members regarding funding.
- Powers for the Pensions Regulator to resolve disputes between trustees and sponsoring employers.

Provisions under the Pensions Act 2004 have given trustees more flexibility in how they run their schemes, enabling them to adapt their scheme to changing circumstances. Schemes are now able to modify the benefits that members have already accrued as long as they have consulted with the members or are replacing benefits with an actuarially equivalent value.

Greater protection for scheme members has also been factored in. Sponsoring employers are now obliged to consult scheme members before making certain changes to scheme rules. The Pensions Regulator is responsible for enforcing this, with the power to issue fines for non-compliance. Changes to future pension arrangements which would require consultation include closing the scheme to new employees and changes in employer contributions.

The Occupational Pension Schemes (Charges and Governance) Regulations 2015 introduced new minimum governance standards for relevant occupational pension schemes to apply from April 2015. Trustees and managers are responsible for ensuring these are maintained. The governance standards involve requirements for trustees to ensure that default arrangements are designed in member's best interests; financial transactions are prompt and accurate; and charges and costs are assessed for value for members.[146]

The Pensions Act 2014 provided for the introduction, from April 2015, of Independent Governance Committees for pension schemes which are not governed by a board of trustees (otherwise known as contract-based schemes). These committees are intended to act, to some extent, as trustees on behalf of members and assess the value for money of the services offered to members. If the schemes do not sufficiently address problems highlighted by the committee, then the committee has the power to escalate concerns to the Financial Conduct Authority.[147]

[146] www.legislation.gov.uk/ukdsi/2015/9780111128329/pdfs/ukdsiem_9780111128329_en.pdf
[147] www.gov.uk/government/uploads/system/uploads/attachment_data/file/298436/better-workplace-pensions-march-2014.pdf; http://www.legislation.gov.uk/ukpga/2014/19/part/6

Third tier: Tax treatment of private pension provision

The tax treatment of private pension provision is generally expressed as EET – Exempt, Exempt, Taxed. Contributions into a pension fund are exempt from tax, the accumulation of the fund is partially exempt from tax and the majority of the proceeds are taxable.

As a portion of the fund sum can be taken tax-free after minimum pension age, the final 'T' is only partial. The accumulation is also not fully 'E'. The extent of taxation on the fund accumulation depends on the mix of investments within the pension fund, and the marginal tax rate paid by the individual. The roll up of funds invested directly in bonds, property or cash is completely tax-free. However, since 1997, dividend income from equities has been taxed at a Corporation Tax rate, although capital gains remain tax-free.

Prior to April 2006, contributions to and benefits from pension schemes qualified for tax relief according to limits which were closely related to how much an individual earned.[148] There were 8 different regimes, depending on the type of pension scheme in operation.

The Finance Act 2004 introduced measures to simplify the tax treatment of private pensions.[149] From April 2006 there is one single regime, which is the same for all types of pension. The key features of this regime are the introduction of the annual allowance and lifetime allowance, which limit the amount of tax relief received.[150]

Contributions – 'Exempt'
Employer contributions are paid gross and if they are treated by HM Revenue and Customs as an eligible expense the employer will get full relief against Corporation Tax. Making pension contributions on behalf of employees has an additional tax advantage for the employer, as employers' pension contributions are not eligible for National Insurance contributions.

Employee contributions up to the greater of £3,600 and 100% of earnings can be offset against income tax – individuals receive tax relief at their highest marginal rate. In some cases full relief is available immediately whereas in other cases basic rate relief is given immediately and higher rate relief is reclaimed through the end-of-year tax return.

[148] For contributions of more than £3,600 a year
[149] Inland Revenue (IR) (2003) *Simplifying the taxation of pension: the Government's Proposals* webarchive.nationalarchives.gov.uk/20100104203713/http:/hmrc.gov.uk/consult_new/pensions_consult.pdf and Her Majesty's Treasury (HMT) (2004) *Prudence for a purpose: A Britain of stability and strength*, Budget report, webarchive.nationalarchives.gov.uk; www.hm-treasury.gov.uk/media/1/B/Budget_2004.pdf
[150] RN Third tier: Overview of private pension provision

From April 2006 there is no limit to the amount of contributions that can be paid into a pension scheme (although some pension schemes may not accept contributions from individuals that do not qualify for tax relief).

In any year, if the total contribution made to Defined Contribution schemes and/or the increase in value of benefits under Defined Benefit schemes for an individual are more than the annual allowance (AA) of £40,000 in 2015/16, the contributions in excess will be taxed at the rate of 40% on the excess.[151]

Under the provisions of the Finance Act 2011, which reduced the annual allowance from £255,000 to £50,000 from 6 April 2011, individuals were able to carry forward any unused allowance from the three preceding years. For Defined Benefit schemes, the valuation factor used to calculate the value of Defined Benefit pension savings has increased from a factor of 10 to a factor of 16.

Upon accessing benefits in retirement, an individual's total pension savings will be tested against a lifetime allowance (LTA), whose purpose is to regulate the amount of tax relief individuals get over their working life. In 2015/16, the LTA is £1.25 million. Any excess over this limit will be taxed at 25% if the benefits are taken as a pension or 55% if they are taken as a lump sum. The Lifetime Allowance will be reduced to £1 million in April 2016.[152]

Fund Accumulation – mainly 'Exempt'
The pension fund accumulates in a tax-favoured environment – there is no tax on interest or income received gross and no tax on any realised capital gains. However, since 1997 pension funds have not been able to reclaim Advance Corporation Tax (ACT) on UK dividends.[153]

From April 2006, an individual can build up their pension funds tax-free until the total exceeds the annual allowance in any given year (for the tax year 2015/16 this is £40,000), or the lifetime allowance, £1.5 million in 2015/16.

Proceeds – mainly 'Taxable'
From age 55, up to 25% of Defined Contribution pension savings can be taken as a tax-free lump sum. The remainder of the fund can be withdrawn flexibly or some, or all of it can be used to purchase a retirement income product such as a lifetime, fixed or flexible annuity, an income drawdown product, or another product which offers income, savings and/or insurance. Because of the newness of the freedom and

[151] www.hmrc.gov.uk/pensionschemes/understanding-aa.htm
[152] www.gov.uk/government/publications/budget-2015-hm-revenue-and-customs-overview/hmrc-overview#savings-personal-tax-national-insurance-and-pensions
[153] PPI (2005) Briefing Note Number 22 Is £5 billion being taken from pension funds each year? www.pensionspolicyinstitute.org.uk/default.asp?p=124&publication=0193

choice policy of flexible access, it is not yet known exactly how many different products might be available or what they will look like. However, people's income in retirement from pension savings will be taxed at their marginal rate at the point of receipt.

Pension funds in excess of the lifetime allowance can still be taken as pension benefit, but they are subject to a different tax rate. When taken as a cash lump sum, the excess is subject to 55% tax. When taken as a pension benefit, the excess is subject to 25% tax, with the income payments taxable as earned income.

Death prior to retirement
If an individual dies before converting their pension savings into an income, the accumulated fund, plus any insured lump sum death benefit, can be paid out tax-free up to the member's available lifetime allowance. Inherited pension savings (with the exception of lifetime annuities without capital guarantees) are tax-free if the fund-holder dies under the age of 75 with uncrystallised funds or funds in a drawdown account. Inherited pension savings are taxed at marginal rate if the fund-holder dies over the age of 75 with uncrystallised funds or funds in a drawdown account. Inherited pensions are taxed at 45% if the fund-holder dies over the age of 75 and the beneficiary takes it as a lump sum (from 2016-17, those taking a lump sum in these circumstances will be taxed at their marginal rate).

Acknowledgements and contact details

This document is intended to provide a description of the UK pensions system for the purpose of considering pensions policy. It should not be used to make individual pensions decisions.

Every effort has been made to avoid error, but in such a complicated field unintentional errors and omissions may remain. Please contact the PPI if any data appears to be out-of-date, or to suggest additional subjects for Reference Notes.

The PPI is grateful for input from Michael Martin, Sue Ward, Keith Bell and Karen Smyth in support of earlier versions of this paper.

The Pensions Policy Institute takes responsibility for remaining errors.

The Pensions Policy Institute is an educational charity promoting the study of retirement provision through research, analysis, discussion and publication. The PPI takes an independent view across the entire pensions system.

The PPI is funded by donations, grants and benefits-in-kind from a range of organisations, as well as being commissioned for research projects. To learn more about the PPI, see: www.pensionspolicyinstitute.org.uk.

Contact:
Sarah Luheshi, Deputy Director
Telephone: 020 7848 3744
Email: info@pensionspolicyinstitute.org.uk

Pensions Policy Institute
King's College
26 Drury Lane
London WC2B 5RL

The PPI is grateful for the continuing support of its Platinum & Gold members:

Platinum

JLT	J.P. Morgan Asset Management
Just Retirement	Prudential UK & Europe
The Pensions Regulator	Columbia Threadneedle Investments

Gold

AXA Investment Managers	Alliance Bernstein (AB)
BlackRock	Capita Employee Benefits
DWP	Hymans Robertson
NEST	RPMI
Standard Life Group	The People's Pension

A full list of supporting members is on the PPI's website.

Published by
PENSIONS POLICY INSTITUTE

PPI

www.pensionspolicyinstitute.org.uk