Occupational and Personal Pension Schemes

REVIEW OF CERTAIN CONTRACTING-OUT TERMS

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

The Social Security (Reduced Rates of Class 1 Contributions, Rebates and Minimum Contributions) Order 2006

Cm 6758

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Presented to Parliament by the Secretary of State for Work and Pensions by Command of Her Majesty
March 2006

Cm 6758 £7.00

Pension Schemes Act 1993

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

To: The Right Hon. John Hutton MP
Secretary of State for Work and Pensions

1. Introduction

Legal basis

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

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

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

Current levels of rebate and recent changes in legislation

1.4 The previous reviews under the appropriate sections of the Act were laid before Parliament in March 2001 (Cm 5076) and related to the five years from April 2002.

1.5 The reduced rates of Class 1 contributions for members of COSRS which came into effect on 6 April 2002 are specified in section 41 of the Act, namely:
(a) in the case of a primary (employee's) Class 1 contribution, a reduction in total contribution of 1.6% of upper band earnings (that is, earnings between the lower and upper earnings limits); and
(b) in the case of a secondary (employer's) Class 1 contribution, a reduction in total contribution of 3.5% of upper band earnings.
The total contribution reduction for employee and employer combined was thus set at 5.1% of upper band earnings. This was in line with my recommendations contained in Cm 5076.

1.6 The reductions in rates of contributions and rebates (paid directly to the scheme by Her Majesty's Revenue and Customs) currently in force for members of COMPS are set out in the Social Security (Reduced Rates of Class 1 Contributions, and Rebates) (Money Purchase Contracted-out Schemes) Order 2001 (SI 2001/1355). This was approved by Parliament following the laying of the previous review mentioned above (Cm 5076). Similarly, the rebates currently in force for members of APPs are set out in the Social Security (Minimum Contributions to Appropriate Personal Pension Schemes) Order 2001 (SI 2001/1354), which was also approved by Parliament following the laying of the previous review (Cm 5076).

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

1.7 The Child Support, Pensions and Social Security Act 2000 reformed the additional pension (commonly known as the State Earnings-Related Pension Scheme or SERPS) through the introduction of the State Second Pension. This Act also made changes to the contracting out arrangements. In particular, following the introduction of the State Second Pension in April 2002, in certain circumstances only a part of the State Second Pension will be given up by those contracted out.

1.8 Schedule 9 to the Welfare Reform and Pensions Act 1999 introduced considerable changes to the parts of the Social Security Contributions and Benefits Act 1992 which deal with National Insurance contributions, as did the Social Security Act 1998. In effect, from April 2000, primary and secondary National Insurance contributions have not been payable on earnings between the lower earnings limit and the "primary threshold" and the "secondary threshold" respectively. From April 2001, both the primary and secondary thresholds have been aligned with the single person's tax allowance, somewhat above the lower earnings limit. However, the reductions in rates of contributions and rebates are still assessed by reference to earnings between the lower and upper earnings limits.

1.9 In assessing the actuarial value of the benefits given up, reference should be made to the nature of any survivors' pensions payable. The only change to the legislation affecting either the nature of contracting out or the benefits forgone since the previous contracting out review is the Civil Partnership Act 2004, which came into effect in December 2005. Under this Act same-sex couples are able to make a formal, legal commitment to each other by forming a civil partnership. Previously, same-sex couples had no such formal legal recognition of their relationships. In broad terms, as a result of the Act, civil partners are treated in the same way as married couples for the purpose of calculating benefit entitlement under the State Second Pension. Given the small number of people to whom the Civil Partnership Act 2004 is expected to apply[2] relative to the number of contracted-out workers, and the nature of the assumptions made in the calculation of the rebates, principally the proportion of contracted-out workers assumed to be married, any change in the rebates on account of the Act would be very small.

1.10 This report covers my review of the rebate appropriate to persons contracted out through COSRS, COMPS (including, as appropriate, the relevant sections of any Contracted-Out Mixed Benefit Schemes) and APPs in relation to the five year period commencing on 6 April 2007. Rebates appropriate for members of APPs and COMPS would also be appropriate where such schemes are stakeholder pensions, under the terms of the Welfare Reform and Pensions Act 1999. Although section 7 of that Act permits different rates of rebate to be set for COMPS and APPs according to whether or not they are stakeholder pension schemes, I do not recommend different rates of rebate for this purpose.

2. General principles

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

2.2 The changes made to additional pension by the Child Support, Pensions and Social Security Act 2000 – the reform of SERPS through the introduction of the State Second Pension – serve to increase the amount of additional pension accruing in each year for many members of the scheme, and to leave the amount of additional pension unchanged for other members. However, the benefit which members of contracted-out occupational pension schemes will give up is not, by and large, altered by the 2000 Act.

2.3 For members of APPs the amount of benefit given up reflects the different accrual rates for the State Second Pension that apply to different earnings bands (bands 1, 2 and 3 in Schedule 4A to the Social Security Contributions and Benefits Act 1992 – also described in paragraph 10 of Appendix A(i) of this report). Where this report shows a single rate for the rebate for a member of an APP as a proportion of upper band earnings, this is the rate that will apply to band 3 earnings, where accrual continues, broadly, at the rate that was applicable under SERPS. Twice the rate shown would apply to band 1 and half the rate shown would apply to band 2. The required minimum contribution will be calculated as the sum of the products of the rebate rates shown, the appropriate multiples and the earnings in each of the bands, and be paid by the National Insurance Contributions Office of Her Majesty's Revenue and Customs to the APP.

[2] See, for example, the Regulatory Impact Assessment that accompanied the Civil Partnership Act 2004.

2.4 In considering the cost of providing benefits of an actuarial value equivalent to the additional pension benefit given up, assumptions must be made about the future levels of the following factors:

(i) the yield on investments;

(ii) the annual increase in the general level of earnings;

(iii) the annual increase in the Retail Prices Index; and

(iv) rates of mortality for men and women, proportions married and the relative ages of husbands and wives.

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

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

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

2.8 Contracted-out pension schemes are not required to underpin the benefits provided by the scheme with the amount of the additional pension benefit given up. Instead COSRS are required to provide pensions broadly equivalent to, or better than, a reference scheme. COMPS and APPs are required to designate funds arising from payment of rebates as "protected rights" and to discharge liabilities in respect of such funds only in certain specified manners.

2.9 In setting the assumptions used to calculate the contracted-out rebates I have had regard to the fact that the decision to contract out is an option taken by or on behalf of workers, and so:

- The contracted-out worker has already chosen to forgo additional pension benefits from the National Insurance Fund from state pension age, or the COSRS or COMPS of which the worker is a member has accepted the responsibility of providing benefits which are considered to be of equivalent actuarial value to the additional pension benefits forgone by the worker, in exchange for the rebates received.
- Therefore, the rebates I have calculated are not set at a level that *guarantees* that the accumulated rebates will be sufficient to provide the same level of additional pension benefits as that forgone from the National Insurance Fund (so, for example, the rebates are not calculated on the assumption that they will be invested in index-linked gilts of appropriate duration). The rebates are calculated so that the accumulated value of the rebates is *expected*, on the assumptions made, to be sufficient to provide benefits of actuarial value equivalent to that of the additional pension benefits forgone.

2.10 As the rebates are not set on a basis that guarantees to reproduce the additional pension benefit forgone, there is a risk that the rebates will actually produce benefits that are lower than those forgone as a result of contracting out. A worker or scheme that does not wish to accept this risk may therefore consider that their best option is not to contract out. It is important that individuals and schemes understand the risks they are accepting as a result of contracting out and this will be a key part of any advice provided about the merits or otherwise of contracting out.

2.11 There have been a number of changes to legislation since the previous review that affect the financing of private sector defined benefit occupational pension schemes, many of which will be COSRS. In particular, rules have been introduced imposing a higher "debt" on a solvent employer whose pension scheme is wound up (see the Occupational Pension Schemes (Winding Up and Deficiency on Winding Up etc) (Amendment) Regulations 2004, SI 2004/403) and the Pension Protection Fund (PPF) has been set up. The PPF has been designed to pay compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer, and where there are insufficient assets in the scheme to cover PPF levels of compensation. In addition, new requirements governing the funding of private sector pension schemes have been implemented to replace the Minimum Funding Requirement. Despite these changes, I consider that the approach I outlined in paragraph 2.9 above remains appropriate and reflects the "the cost of providing benefits of an actuarial value equivalent to … the benefits …forgone", as required by legislation.

3. Contracted-out salary related schemes

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

(a) a report by the Government Actuary or the Deputy Government Actuary on

(i) the percentages for the time being applying under section 41(1A) and (1B), and

(ii) any changes since the preparation of the last report under this paragraph in the factors in his opinion affecting the cost of providing benefits of an actuarial value equivalent to that of the benefits (or parts of benefits) which, in accordance with section 48A below and Schedule 4A to the Social Security Contributions and Benefits Act 1992, are foregone by or in respect of members of salary related contracted-out schemes.

(b) …..

Pension Schemes Act 1993, section 42(1)

Post-retirement net rate of return

3.1 The additional pension benefit given up as a result of contracting out would have been indexed from state pension age according to increases in the Retail Prices Index (RPI). Such a stream of payments therefore has some similarities with the cash-flows associated with index-linked UK government bonds (index-linked gilts). In deciding on an appropriate post-retirement net rate of return, regard could be paid to the yield to be expected from investment in index-linked gilts. However, the additional pension benefits forgone by contracted-out workers (in respect of the periods for which the workers were contracted-out) are financed through pension schemes rather than through the National Insurance Fund. Therefore, the cost of providing pension benefits after retirement from COSRS should also have regard to the yields on corporate and other less marketable borrowings of appropriate term and security, rather than just by reference to gilt yields.

3.2 The annualized gross redemption yields on the FT-Actuaries Index of index-linked gilts with redemption dates more than five years into the future, assuming future price inflation of 5% a year, are illustrated in Appendix B. This shows that these real annual gross redemption yields were broadly in the range 3.25% a year to 4.5% a year over the period from 1985 until 1997. However, since 1997, annualized gross redemption yields have fallen to previously unprecedented levels, standing at around 1% a year in mid-January 2006. For more recent periods figures have been published assuming inflation of 0% a year. Interpolating between figures for the two different inflation assumptions suggests that, on an assumption of inflation of 2½% a year, yields would currently be about 0.1% higher than the figures shown in Appendix B.

3.3 Yields on longer-dated high quality corporate bonds stood at around 4½% a year in the middle of January 2006. Unlike the yield on index-linked gilts, this is a nominal rather than a real yield (i.e. it is not in addition to the effect of price inflation). In order to produce a real yield it is necessary to remove the effect of inflation. The future rate of RPI inflation that is implied by the yields on index-linked and conventional UK government bonds is about 2¾% a year in mid-January 2006, which in turn suggests a real yield on corporate bonds of somewhat over 1½% a year.

3.4 The assumption relates to the rate of return after retirement for employees accruing benefits in the period from 2007-08 to 2011-12 and therefore the time horizon is a long one. I do not consider it likely that real yields will remain permanently at their current historically low levels and I therefore propose a net rate of return after retirement, relative to price increases, of 2.0% a year for all future years.

3.5 This is lower than the rate I recommended at previous reviews. In particular, for rebates in the period 2002-03 to 2006-07, it was assumed that the post-retirement rate of investment return relative to price increases would be 2.0% a year for those reaching state pension age in 2002-03, increasing gradually to reach 3.5% a year for those reaching state pension age in 2017-18 and later years. The reduction in the assumed return reflects the fact that there is little evidence in the financial markets to suggest any widespread belief that yields will recover substantially to levels of around 3.5% a year, as seen in the past.

Pre-retirement net rate of return

3.6 For the period before state pension age, I consider that the rebates will normally be invested in a *range* of asset classes, for the same reasons that apply to most retirement savings. Investors in riskier assets such as equities (and other asset classes such as property) will have an expectation that these assets will produce higher returns in the longer term than are available from appropriate government bonds (which are generally thought of as 'risk-free' – in the sense of offering virtually certain payments, which may provide a close match to certain liabilities). It is usually expected that the longer the term until the investor's retirement age the larger the proportion of retirement savings that will be invested in riskier assets such as equities.

3.7 A judgement has to be made as to the extent to which any such higher expected rates of return should be allowed for in determining the "cost of providing benefits of an actuarial value equivalent to that of the benefits … forgone".

3.8 Most investments will have an upside and a downside risk[3], even though most investors would be more concerned with downside risk and typically the 'risk' they refer to is downside risk. The market price of risk is a measure of the additional expected return on an investment that the average market participant is willing to give up to protect themselves from the downside risk of the same investment. Thus, the market price of risk is usually positive[4] and the expected return on the 'risky' asset is usually higher than the expected return on the risk-free asset – since the average investor is usually risk-averse, and requires some compensation for making the risky investment. Although equities are thought of as 'risky', and government bonds as risk-free, in practice the return on any investment strategy is never known with certainty at the outset, and so there is some degree of uncertainty about the returns on all assets (and hence there is no asset that is entirely risk-free, in particular with regard to meeting a given set of liabilities).

3.9 The decision to contract out is made, among other reasons, because it allows the contracted-out worker or scheme to access the upside risk of investing rebates in the financial markets. The downside risk, of poorer than expected returns on the invested rebates, is in effect accepted as a consequence of the contracting out decision. If a worker or scheme wants to be protected against this specific downside risk, the simplest option available to them is not to contract out. Therefore, it does not follow that the rebates should provide full compensation at the market implied risk premium for the protection voluntarily given up. This is particularly the case for investors who have a different investment horizon (time-frame) from the average market participant.

3.10 Therefore, I have made an estimate of the equity risk premium expected over the period that the rebates will be invested, and have allowed for this in calculating the contracted-out rebates. A worker, or a scheme, as (or more) risk-averse as the average market participant may not consider that they are best served by contracting out. It is more consistent with my interpretation of the legislation to propose rebates that a more risk-tolerant worker or scheme would accept as an alternative to the additional state pension benefits forgone.

3.11 I have considered a range of research available on the appropriate value of the equity risk premium, although it needs to be borne in mind that there is a variety of approaches to how it should be estimated. Estimates of the equity risk premium range widely, for example from under 3% a year to over 8% a year.[5]

3.12 I consider that it would be appropriate to assume that the typical investment portfolio for the contracted-out worker will be broadly bond-based approaching state pension age, with increasing proportions of the portfolio in equity investments at younger ages. Taking into account the available evidence on the equity risk premium, I recommend a real rate of return before retirement relative to prices starting at 2% a year (for those near pension age) and rising to 4% a year (for each year to pension age) for those more than 30 years from pension age. These figures are assumed to be net of investment management expenses.

3.13 Additional state pension benefits are linked to increases in the Average Earnings Index (AEI) for the period between the year to which the earnings relate and the year before reaching state pension age. For this purpose, each year, the Secretary of State for Work and Pensions publishes a "Revaluation of earnings factors order", based on the increase in the AEI over the 12 months to the preceding September.

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[3] Downside risk is the risk to the investor that the investment returns are less than expected. Upside risk is the risk that the investment returns more than expected. Risk is an opportunity as much as a cost, in appropriate hands.

[4] This means that the average investor must be "paid" to take risk. In finance literature this payment (to hold equities instead of government bonds) is known variously as the risk premium, the market premium or the equity risk premium.

[5] For example, see "Triumph of the Optimists" by Dimson, Marsh and Staunton, Princeton University Press, 2002. They suggest a forward-looking, geometric mean risk premium of about 3% a year, and a corresponding arithmetic mean risk premium of about 4% a year.

3.14 The history of increases in the index of average earnings relative to the Retail Prices Index is given in Appendix C. This indicates that the long-term rate of increase in real earnings has generally been between 1.5% and 2.0% a year, but for more recent periods there is evidence of a more moderate rate of real earnings growth. I therefore propose to use a rate of real earnings growth of 1% a year in the short term (affecting the rebates of those close to pension age) and a higher longer term real rate of growth of 1.5% a year.

3.15 Combining my assumptions for the investment return relative to price inflation and real earnings growth produces an overall assumption for the rate of return in excess of increases in average earnings of 1% a year for those at the oldest ages, rising to 2% a year (for each year to pension age) for those aged 50 and rising further to 2½% a year (for each year to pension age) for those aged 35 or less.

3.16 The rate of investment return relative to earnings which I proposed and which was adopted for the period from 2002-03 to 2006-07 was 2.0% a year at all ages. Therefore, the assumption I am proposing on this occasion is slightly higher at the younger ages and lower at the older ages. Overall, for an average COSRS, the assumed rate of investment return before retirement relative to earnings is not very different from what was assumed previously.

Nominal rate of return

3.17 An assumption about future nominal rates of return is required only for the period of one year before reaching state pension age, when there is no earnings indexation of the accrued additional pension benefit. Having regard to the other financial assumptions, the nominal rate of investment return I propose is 5% a year.

3.18 This is lower than the rate proposed at the previous review (6%), and this reduction reflects my allowance for lower rates of investment return at ages close to and above pension age.

Longevity

3.19 The Government Actuary's Department has been studying the mortality of the population of the United Kingdom over a considerable period. This work is the basis for the regular official projections of the population of the United Kingdom and its constituent countries. The latest such projections are 2004-based and were published in October 2005. However, the mortality of members of COSRS is frequently lighter than that of the general population. I have therefore made a comparison of the mortality of the population as a whole and that of members of COSRS, using administrative data from the Department for Work and Pensions. Based on this analysis, I propose that the mortality of members of COSRS should be assumed to be 85% of the projected mortality used for the UK 2004-based population projections. I have also assumed the same proportion of population mortality for the widows and widowers of members of COSRS.

3.20 The mortality of members of insured pension schemes has been studied by the Continuous Mortality Investigation (CMI), a joint committee of the Faculty of Actuaries and the Institute of Actuaries. However, it should be noted that life office pensioners represent only a small proportion of members of occupational pension schemes. This means that the CMI experience may not be directly applicable to those who are contracted out. Although the CMI has carried out some analysis of the mortality of members of large self-administered pension schemes, so far this has been quite limited in scope and has not included the preparation of standard tables. This analysis does, however, suggest that the mortality of members of larger occupational schemes might tend to be heavier than that shown in the main CMI tables for life office pensioners.

3.21 A comparison, in the form of cohort expectations of life, between the mortality rates proposed and those contained in the latest standard mortality tables published by the CMI for use in connection with insured pension schemes (tables PMA92 and PFA92 allowing for "medium cohort" future mortality improvement) is shown in the table below.

Expectations of life at age 65

Year of attaining age 65	Men		Women	
	PMA92 with medium cohort improvement	Proposed rate – 85% of UK population mortality rates as projected by GAD (2004-based)	PFA92 with medium cohort improvement	Proposed rate – 85% of UK population mortality rates as projected by GAD (2004-based)
2010	22.09	21.49	24.97	23.99
2020	22.68	22.43	25.52	24.88
2040	23.48	24.25	26.25	26.59

3.22 At the previous review, it was also assumed that the mortality of members of COSRS would be 85% of population mortality. However, this was based on the assumptions underlying the 1998-based population mortality projections. On this occasion I propose that mortality assumptions based on the 2004-based projections should be adopted and these incorporate a much greater allowance for future mortality improvement than was included in the 1998-based projections. This change reflects the expectation of greater future improvements in mortality.

Marital status

3.23 Part of the accrued additional pension will be paid to a surviving legal spouse at the date of death of the contributor in the circumstances outlined in Appendix A(ii), reflecting the changes introduced by the Welfare Reform and Pensions Act 1999. In order to place a value on this benefit, I have used the 2003-based projections of the population of England and Wales by legal marital status, which were also prepared by the Government Actuary's Department. I have also assumed that husband-wife age disparities are broadly in line with the experience for the population of Great Britain, as revealed in the latest (2001) census. This is the same approach as at the previous review but takes into account the latest available evidence on these matters. These assumptions are deemed to include appropriate allowance for civil partners.

Weights

3.24 The reduction in the Class 1 contribution for members of COSRS will continue to be a single percentage of upper band earnings, independent of sex and age. It is necessary, therefore, to weight the individual age- and sex-related rebates to obtain the appropriate average rebate. The necessary weights have been derived from data analysed by the Department for Work and Pensions. There has been a trend over time in the weights observed and it is appropriate to project the trend to the mid-point of the quinquennium 2007-08 to 2011-12. The weights which I have adopted for the period 2007-08 to 2011-12 are given in Appendix D. These weights reflect a higher proportion of women than at the previous review.

3.25 Currently, the contribution reductions for those who remain in a COSRS for two years or less are, in effect, cancelled through the payment of contribution equivalent premiums (CEPs). The rules are changing with effect from April 2006 so that CEPs will cease to be payable for those members who leave the scheme with between three months' and two years' service and who elect to receive a cash equivalent transfer value of their accrued benefit. In the previous review it was considered that a satisfactory method of allowing for the payment of CEPs was to exclude from the weights one-third of the earnings of those under the age of 25. This approximation is still considered suitable, given that the effect is small and the impact of the new rules is uncertain.

Contingency margin

3.26 In past reviews a margin of 7.5% of the calculated rebate has been included to enable schemes with an older than average age distribution to contract out. The COSRS rebate will continue to be the weighted average of the age- and sex-related rebates and I consider it appropriate to retain this contingency margin.

3.27 The introduction of the Pension Protection Fund (PPF) from 6 April 2005 has also had an impact on the costs of private sector COSRS. However, the PPF only increases the costs of contracting out if schemes would reduce the benefits offered (and therefore any pension protection levy) as part of any decision to cease contracting out. In practice, I intend to consider the levy as being covered by the contingency margin.

Expense loading

3.28 At the previous review an allowance for expenses expressed as 0.2% of upper band earnings was incorporated into the rebate. This was intended to allow for the marginal cost of having a contracted-out rather than a "contracted-in" scheme. Since the abolition of the formal requirement for periodic actuarial certification that the pensions to be provided are broadly equivalent to or better than the pensions which would be provided under a prescribed reference scheme, these costs are likely to be small for most COSRS, although they will be proportionately larger for smaller schemes. In order to allow for the costs associated with being contracted out to be covered by moderately-sized schemes, I have considered it appropriate to retain the expense loading of 0.2% of upper band earnings.

COSRS rebate

3.29 Using the actuarial assumptions described above, the weighted rebate, including the expense loading and the contingency margin, is 5.8% of upper band earnings. I understand that the split of this amount into elements to be deducted from primary and secondary contributions will be addressed in the report you present to Parliament at the same time as this report.

3.30 The key actuarial factors in determining the COSRS rebate are the pre- and post-retirement net rates of return. The sensitivity of the calculated rebate (including the expense loading) to changes in these factors is indicated in the following table.

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

Annual rate of investment return pre-retirement relative to earnings increases (see paragraph 3.15)	Annual rate of investment return post-retirement relative to price increases (see paragraph 3.4)		
	1.5%	**2.0%**	2.5%
0.5% - 2.0%	6.7%	6.3%	5.9%
1% - 2.5%	6.2%	**5.8%**	5.4%
1.5% - 3.0%	5.7%	5.3%	5.0%

3.31 The key factors leading to the change in the rebate proposed for the quinquennium 2007-08 to 2011-12 from that in the current quinquennium are set out in the table below:

National Insurance rebate for COSRS as a percentage of upper band earnings (including allowance for the contingency margin and expense loading)

Rebate adopted for quinquennium 2002-03 to 2006-07		5.1%
Effect of declining additional pension accrual rates and increase in pension age for women		-0.6%
Effect of changing mortality and other demographic assumptions		+0.5%
Effect of changing economic assumptions	pre-retirement rate	-0.2%
	post-retirement rate	+0.8%
Effect of changing weighting		+0.2%
Proposed rebate for quinquennium 2007-08 to 2011-12		5.8%

4. Contracted-out money purchase schemes

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

(a) *a report by the Government Actuary or the Deputy Government Actuary on the percentages which, in his opinion, are required to be specified in an order under this section so as to reflect the cost of providing benefits of an actuarial value equivalent to that of the benefits (or parts of the benefits) which, in accordance with section 48A below and Schedule 4A to the Social Security Contributions and Benefits Act 1992, are foregone by or in respect of members of money purchase contracted-out schemes,*

(b) ….

Pension Schemes Act 1993, section 42B(1)

Post-retirement rate of return relative to price increases

4.1 In paragraph 3.1 I noted that, in relation to COSRS, the post-retirement net rate of return could be set having regard to the yields on index-linked government securities and on corporate borrowings of appropriate term and duration. I consider that the same factors apply in the case of COMPS. Hence I propose to use an annual rate of return after retirement relative to price increases of 2.0% a year for all future years.

Pre-retirement rate of return relative to earnings increases

4.2 The question of a suitable net rate of return before retirement was discussed in relation to COSRS. Similar arguments apply to rebates to be paid to COMPS. I have considered it appropriate, therefore, to use the same pre-retirement net rate of return as that adopted for calculating the rebate in respect of COSRS. Accordingly I have used a net rate of return relative to average earnings increases of 1% a year for those at the oldest ages, rising to 2% a year (for each year to pension age) for those aged 50 and rising further to 2½% a year (for each year to pension age) for those aged 35 or less.

Nominal rate of return

4.3 Where an assumption about the nominal rate of return is required, I have used a rate of 5% a year, which is the same as the figure adopted for COSRS (see paragraph 3.17). In particular, sections 42A(2), (2A) and (3) of the Act provide for an appropriate flat-rate rebate to be paid during the financial year and the balance of the total age-related rebate later. Allowance has been made for the balance of the age-related rebate in excess of the flat-rate element to be paid to COMPS on average 12 months after the middle of the financial year in which they were granted and I have therefore allowed for an additional one year's investment return on this element of the rebate.

Demographic factors

4.4 If a married contributor to the additional pension scheme were to die before state pension age the spouse would be paid a pension at the level described in Appendix A(ii). The benefit is not paid automatically and the conditions for payment are also described. Once the rebates are paid into a COMPS they are designated as "protected rights". If COMPS rebates made allowance for mortality before state pension age, and the actuarial assumptions were borne out, the amount available at state pension age for those who survived to that age would be insufficient to provide a benefit of an actuarial value equivalent to the value of the additional pension benefit given up. I have therefore, as at past reviews, omitted any allowance for mortality before state pension age in calculating the amount of the rebate.

4.5 Workers in COMPS will generally purchase an annuity from an insurance company at retirement. I understand that insurance companies currently appear to be pricing their annuity products using the PMA92 and PFA92 annuity tables with allowance for medium cohort improvements, as published by the CMI (see paragraph 3.21). Therefore, for COMPS, I have adopted these tables for ages above state pension age.

4.6 In assessing the actuarial value of the additional pension benefit given up, I have assumed that all COMPS members are married at the date on which state pension age is attained. The relative ages of husbands and wives adopted for COSRS have been retained for COMPS.

Expense loadings

4.7 As for the previous review, I have made an allowance for expenses in rebates for COMPS on a consistent basis with that for COSRS. This approach was originally adopted to reflect the legislative changes that came into force in 1997, which allowed greater flexibility for occupational pension schemes to choose the basis on which they are contracted out. Therefore I have made an addition of 0.2% of upper band earnings to the rates (as a proportion of upper band earnings) calculated on the assumptions above.

4.8 In addition I propose to allow for a 7.5% loading on the annuity factor derived from the mortality and interest rate assumptions described above. This loading is intended to reflect the allowance made in the annuity pricing bases of insurance companies for such matters as administration costs, commission and the cost of capital.

COMPS rebate

4.9 I am advised that the requirements for equal treatment will require payment of the same rebates to men and women of the same age. This applies irrespective of the unequal treatment within the state system with respect to state pension age (to be equalized in the period up to 6 April 2020, as shown in Appendix A(iii)) and, consequentially, the accrual rates of the additional pensions. To provide equal rebates to men and women based on the average cost of benefits given up would make contracting out unattractive to whichever sex has the higher cost. I have, therefore, taken the rebate to be the greater of that calculated for men and women.

4.10 Appendix E sets out the scale of age-related rebates for COMPS using the assumptions described above. The flat-rate element of the rebate for the quinquennium is determined as the lowest rebate applicable for any individual during the quinquennium. For the quinquennium from 2007-08 to 2011-12 this is the rebate applicable for someone aged 15 last birthday at 5 April 2007, i.e. 3.0% of upper band earnings. At the youngest age, therefore, the entire rebate is paid during the financial year and there is no balance payable later.

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

5. Appropriate personal pensions

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

(a) *a report by the Government Actuary or the Deputy Government Actuary on the percentages which, in his opinion, are required to be specified in an order under this section so as to reflect the cost of providing benefits of an actuarial value equivalent to that of the benefits (or parts of benefits) which, in accordance with section 48A below and Schedule 4A to the Social Security Contributions and Benefits Act 1992, are foregone by or in respect of members of appropriate personal pension schemes,*

(b) …..

Pension Schemes Act 1993, section 45A(1)

Post-retirement rate of return relative to price increases

5.1 In paragraph 3.1 I noted that, in relation to COSRS, the post-retirement net rate of return could be set having regard to the yields on index-linked government securities and on corporate borrowings of appropriate term and duration. Again, I consider that the same factors apply in the case of APPs. Hence I propose to use an annual rate of return after retirement relative to price increases of 2.0% a year for all future years.

Pre-retirement rate of return relative to earnings increases

5.2 The question of a suitable net rate of return before retirement was discussed in relation to COSRS. Similar arguments apply to rebates to be paid to APPs. I have considered it appropriate, therefore, to use the same pre-retirement net rate of return as that adopted for calculating the rebate in respect of COSRS. Accordingly I have used a net rate of return relative to average earnings increases of 1% a year for those at the oldest ages, rising to 2% a year (for each year to pension age) for those aged 50 and rising further to 2½% a year (for each year to pension age) for those aged 35 or less.

Nominal rate of return

5.3 Where an assumption about the nominal rate of return is required, I have used a nominal rate of 5% a year, which is the same as the figure adopted for COSRS (see paragraph 3.17). In particular, allowance has been made for rebates to be paid to the APP provider on average 12 months after the middle of the financial year in which they were granted and I have therefore allowed for an additional one year's investment return on the rebate.

Demographic factors

5.4 As with COMPS, the factors set out in paragraph 4.4 imply that it is appropriate to make no allowance for mortality of members of APPs below state pension age. For ages above state pension age, I have adopted the same mortality assumptions as those described in paragraph 4.5 for members of COMPS.

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

Expense loadings

5.6 Stakeholder pensions are subject to a limit on the charges they may levy. Although the same restrictions do not apply to personal pensions, there is evidence that personal pension charges have tended to converge toward the stakeholder level. Regulation 14 of the Stakeholder Pension Schemes Regulations 2000 (SI 2000/1403) (as amended from 6 April 2005 by the Stakeholder Pension Schemes (Amendment) Regulations 2005, SI 2005/577) requires that the only charge stakeholder pensions should make up to retirement age should be an annual charge levied as a proportion of the assets held in the fund to a maximum of 1% a year or, for contracts taken out on or after 6 April 2005, 1.5% a year for the first ten years of membership and 1% a year thereafter.

5.7 Given this, I propose to continue to make a single allowance for expenses in recommending a rebate rate for members of APPs, whether registered as stakeholder pension schemes or not, of a 1% a year reduction in the rate of return before retirement. As for COMPS (see paragraph 4.8) I also propose to allow for a 7.5% loading on the annuity factor derived from the mortality and interest rate assumptions described above in order to allow for the expense charges included in annuity prices.

APP rebates

5.8 The considerations regarding requirements for equal treatment described in paragraph 4.9 apply to rebates for APPs in the same way as they do to rebates for COMPS and require payment of the same rebates to men and women of the same age. Hence, as with rebates for COMPS, I have taken the rebate to be the greater of that calculated for men and women.

5.9 Appendix F sets out the scale of age-related rebates for APPs using the assumptions described above. As set out in paragraph 2.3, the rates apply to earnings in band 3, as defined in paragraph 10 of Appendix A(i), where the State Second Pension given up by those contracted out into APPs continues to accrue at broadly the rate that was applicable under SERPS. A rebate rate of twice the rate shown will apply to earnings in band 1 and one-half of the rate shown will apply to band 2.

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

6. Fixed rate of GMP revaluation

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

6.2 Upon leaving contracted-out employment, one option in relation to accrued GMPs is to revalue at a fixed rate of revaluation until the year before state pension age is attained (as opposed to revaluation in line with increases in national average earnings over that period). The prescribed rates of revaluation are set out in Regulation 62 of the Occupational Pension Schemes (Contracting Out) Regulations 1996 (SI 1996/1172). To date, the rates have been set as shown in the following table.

Date of leaving contracted-out employment	Fixed rate of GMP revaluation
Before 6 April 1988	8.5% a year
After 5 April 1988 and before 6 April 1993	7.5% a year
After 5 April 1993 and before 6 April 1997	7% a year
After 5 April 1997 and before 6 April 2002	6.25% a year
After 5 April 2002	4.5% a year

6.3 These rates have been set at 0.5% a year above the rate of increase in average earnings implied in the actuarial assumptions used to calculate the amount of the contribution reduction for members of COSRS. I recommend that the fixed rate of revaluation should be reduced to 4.0% year for GMPs preserved from 6 April 2007.

Christopher Daykin CB
Fellow of the Institute of Actuaries

Government Actuary's Department

30 January 2006

Appendix A(i)

Additional pension benefits under the State Earnings-Related Pension Scheme and the State Second Pension (S2P)

1. Since April 1978 employees who have paid Class 1 contributions on earnings above the lower earnings limit have been entitled to an earnings-related additional pension, generally referred to as the State Earnings-Related Pension Scheme (SERPS). SERPS applied up to the tax-year 2001-02 and with effect from 6 April 2002 it was replaced by the State Second Pension. The State Second Pension is a modified form of SERPS, incorporating some important changes. The following paragraphs describe first how benefits are calculated under SERPS and they then go on to describe how the calculation is changed under the State Second Pension.

2. Since 6 April 2000, employees earning between the lower earnings limit and the primary threshold for National Insurance contributions are treated as having paid Class 1 contributions and are, therefore, entitled to SERPS. Earnings between the lower and upper earnings limit (upper band earnings) in any tax year are revalued in line with the general level of earnings, up to the final relevant year, which is the year before that in which state pension age is attained. The revalued upper band earnings are then averaged over the period from age 16, or April 1978 if later, to the end of the tax year preceding state pension age. The retirement pension is payable from state pension age and is indexed after that age in line with the general level of prices.

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

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

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

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

Year of retirement	Accrual rate for period 1988-89 onwards
2005-06	22/27
2006-07	21.5/28
2007-08	21/29
2008-09	20.5/30
2009-10	20/31
2010-11	20/32
…	…
2027-28 and later	20/49

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

out employment prior to 5 April 1997 was equal to the GMP that a COSRS would have been required to pay to a worker of the same age and sex who had had the same earnings.

8. The Pensions Act 1995 removed the requirement for contracted-out salary-related occupational pension schemes to provide GMPs in respect of contracted-out service from April 1997 onwards. COSRS are required to provide benefits that comply with the statutory reference scheme standard. COMPS and APPs continue to contract out on the basis that the contributions made to the scheme in respect of employees are not less than the amount of the contracted-out National Insurance contribution reduction and provided that the schemes satisfy certain other requirements. Under the changes introduced by the Pensions Act 1995, contributors did not accrue any SERPS entitlement in respect of contracted-out earnings between April 1997 and April 2002.

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

9. The Child Support, Pensions and Social Security Act 2000 (the 2000 Act) included a number of changes to additional pension, which became known as the State Second Pension from April 2002. The main changes, which took effect from tax year 2002-03, are:

- the introduction of three different accrual rates on different bands of earnings;
- treating those earning between the annualised lower earnings limit (the "qualifying earnings factor" or "QEF") up to the "low earnings threshold" – £12,100 a year in 2005-06 and £12,500 a year in 2006-07 – as though they earned the low earnings threshold; and
- treating qualifying carers and people with long-term disabilities who have no earnings or earnings below the annual lower earnings limit, as if they had earnings at the level of the low earnings threshold.

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

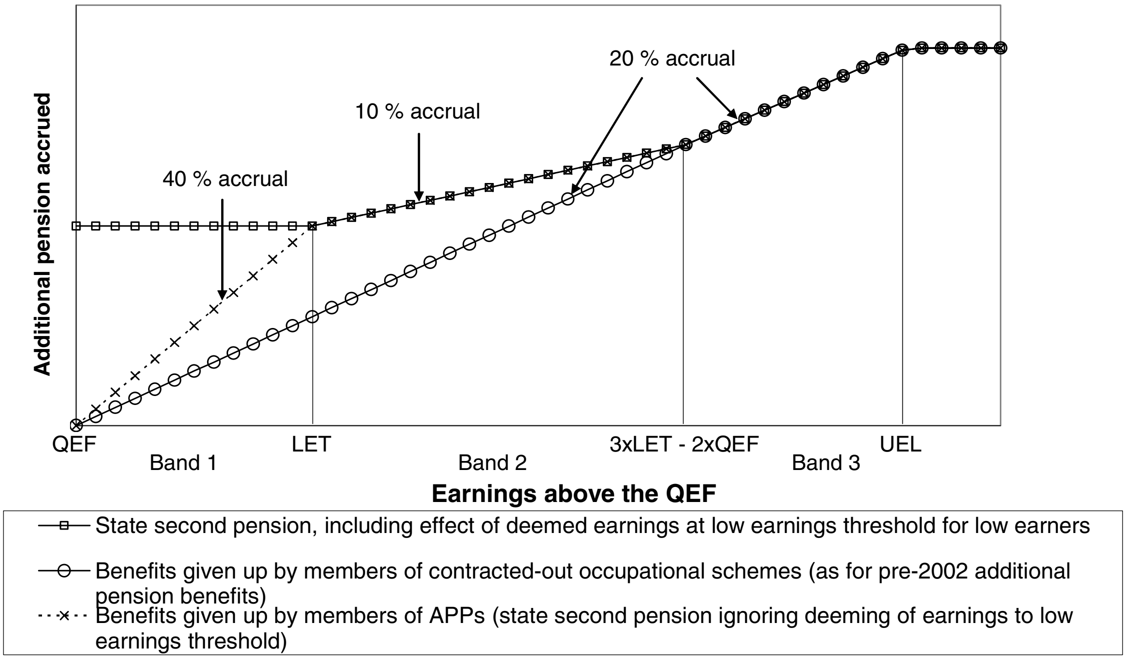
10. State Second Pension accrues on earnings (actual or treated as earned) between the lower earnings limit and the upper earnings limit (as for SERPS). However, earnings between the lower earnings limit and the upper earnings limit are divided into three bands. Band 1 is from the annual lower earnings limit to the low earnings threshold (LET). Band 2 is from the low earnings threshold plus £1 to (3 x LET – 2 x QEF). This is £27,800 in 2005-06 and £28,800 in 2006-07. Band 3 is from the top of the second band plus £1 to the upper earnings limit. The low earnings threshold is increased each year in line with the annual increase in average earnings. Rounding rules apply to the calculation of the low earnings threshold and the calculation of the top of Band 2.

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

12. Under the State Second Pension, COSRS and COMPS rebates will continue to reflect the SERPS accrual rates. This is set out in part III of Schedule 4A to the Social Security Contributions and Benefits Act 1992, which was inserted by section 31(3) of, and Schedule 4 to, the 2000 Act. In particular, paragraph 8(3) of Schedule 4A stipulates that rebates will be based on actual earnings without any deeming of earnings to the level of the low earnings threshold as will occur for additional pension. Members of COSRS and COMPS earning below the top of Band 2 (£27,800 in 2005-06 and £28,800 in 2006-07) will receive a State Second Pension top-up from the National Insurance Fund. This is calculated by first working out the State Second Pension which would have been paid had these members not been contracted out. The top-up will then be determined by deducting from that amount the benefit upon which the rebate calculation is based, reflecting the SERPS accrual rates.

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

14. The graph below aims to illustrate the pattern of benefits that will accrue under the State Second Pension for those retiring in 2009-10 or later, and the pattern of benefits given up by members of contracted-out pension arrangements.



Additional pension accrued
40 % accrual
10 % accrual
20 % accrual
QEF
LET
3xLET - 2xQEF
UEL
Band 1
Band 2
Band 3
Earnings above the QEF
State second pension, including effect of deemed earnings at low earnings threshold for low earners
Benefits given up by members of contracted-out occupational schemes (as for pre-2002 additional pension benefits)
Benefits given up by members of APPs (state second pension ignoring deeming of earnings to low earnings threshold)

Appendix A(ii)

Benefits for widow(er)s

1. An earnings-related additional widow(er)'s pension may be payable in respect of earnings on which contributions have been paid by the member of the additional pension scheme since April 1978. This additional pension accrues in the same way as the additional retirement pension described in Appendix A(i). For deaths after April 1999, the "N" (see paragraph 5 of Appendix A(i)) used to determine the accrual rate is broadly the number of tax years from April 1978 to the end of the tax year preceding the member's death. The additional pension is reduced to reflect any guaranteed minimum pension (GMP) payable to the widow(er) in respect of a period of contracted-out employment or notional GMP in respect of membership of an appropriate personal pension or contracted-out money purchase occupational pension scheme. Indexation of the additional widow(er)'s pension is in line with the general level of prices.

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

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

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

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

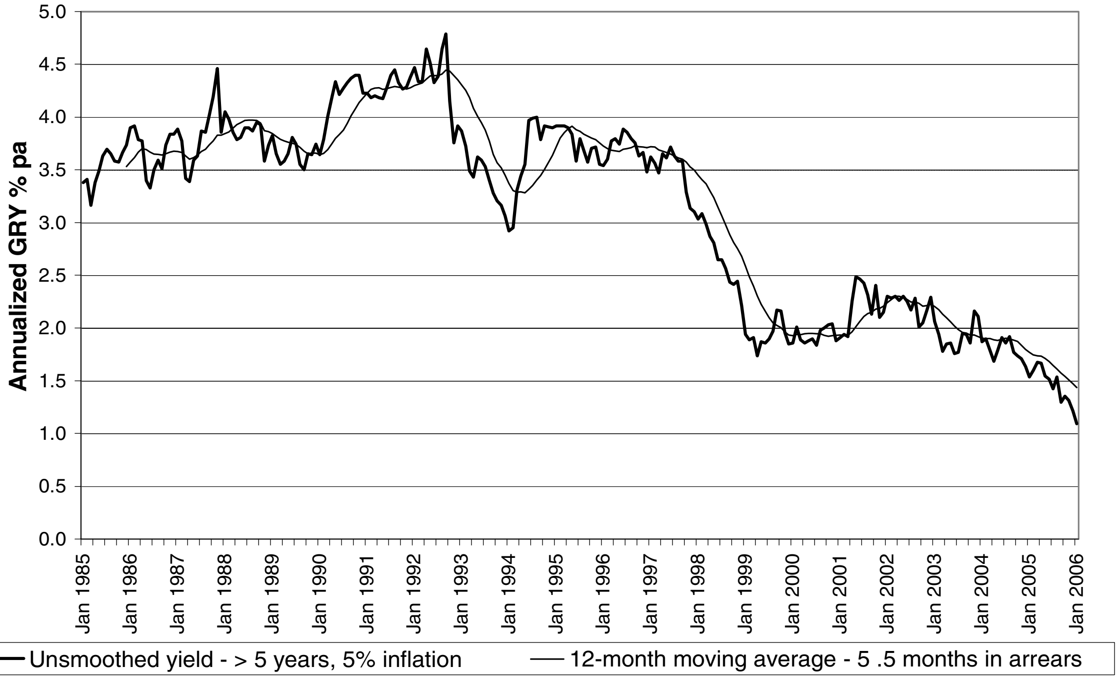
Appendix A(iii)

Phasing of increase to 65 in female state pension age

Date of birth	State pension age (year.month)	Pension date	Date of birth	State pension age (year.month)	Pension date
06.03.50	60.0	06.03.2010	06.10.52	62.7	06.05.2015
06.04.50	60.1	06.05.2010	06.11.52	62.8	06.07.2015
06.05.50	60.2	06.07.2010	06.12.52	62.9	06.09.2015
06.06.50	60.3	06.09.2010	06.01.53	62.10	06.11.2015
06.07.50	60.4	06.11.2010	06.02.53	62.11	06.01.2016
06.08.50	60.5	06.01.2011	06.03.53	63.0	06.03.2016
06.09.50	60.6	06.03.2011	06.04.53	63.1	06.05.2016
06.10.50	60.7	06.05.2011	06.05.53	63.2	06.07.2016
06.11.50	60.8	06.07.2011	06.06.53	63.3	06.09.2016
06.12.50	60.9	06.09.2011	06.07.53	63.4	06.11.2016
06.01.51	60.10	06.11.2011	06.08.53	63.5	06.01.2017
06.02.51	60.11	06.01.2012	06.09.53	63.6	06.03.2017
06.03.51	61.0	06.03.2012	06.10.53	63.7	06.05.2017
06.04.51	61.1	06.05.2012	06.11.53	63.8	06.07.2017
06.05.51	61.2	06.07.2012	06.12.53	63.9	06.09.2017
06.06.51	61.3	06.09.2012	06.01.54	63.10	06.11.2017
06.07.51	61.4	06.11.2012	06.02.54	63.11	06.01.2018
06.08.51	61.5	06.01.2013	06.03.54	64.0	06.03.2018
06.09.51	61.6	06.03.2013	06.04.54	64.1	06.05.2018
06.10.51	61.7	06.05.2013	06.05.54	64.2	06.07.2018
06.11.51	61.8	06.07.2013	06.06.54	64.3	06.09.2018
06.12.51	61.9	06.09.2013	06.07.54	64.4	06.11.2018
06.01.52	61.10	06.11.2013	06.08.54	64.5	06.01.2019
06.02.52	61.11	06.01.2014	06.09.54	64.6	06.03.2019
06.03.52	62.0	06.03.2014	06.10.54	64.7	06.05.2019
06.04.52	62.1	06.05.2014	06.11.54	64.8	06.07.2019
06.05.52	62.2	06.07.2014	06.12.54	64.9	06.09.2019
06.06.52	62.3	06.09.2014	06.01.55	64.10	06.11.2019
06.07.52	62.4	06.11.2014	06.02.55	64.11	06.01.2020
06.08.52	62.5	06.01.2015	06.03.55	65.0	06.03.2020
06.09.52	62.6	06.03.2015	06.04.55	65.0	06.04.2020

Appendix B

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



Source: FTSE Actuaries Government Securities indices

Appendix C

Real increases in earnings

Period of n years to 2004-05	Annualised increase in retail prices index (A)	Annualised increase in average earnings of all employees (B)	Real earnings increase (1+B)/(1+A) – 1
40	6.6%	8.6%	1.8%
20	3.7%	5.5%	1.8%
5	2.5%	4.0%	1.5%
1	3.2%	4.2%	1.0%

The increases shown are the averages for the 12 periods of n years ending in July 2004 to June 2005.

Source: GAD calculations based on indices published by the Office for National Statistics

Appendix D

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

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

Age	Proposed weights		Weights used for current quinquennium	
	Men	Women	Men	Women
16-19	0.000	0.000	0.000	0.000
20-24	0.019	0.011	0.012	0.007
25-29	0.049	0.044	0.037	0.024
30-34	0.045	0.050	0.053	0.035
35-39	0.073	0.077	0.093	0.073
40-44	0.079	0.099	0.113	0.102
45-49	0.079	0.107	0.102	0.097
50-54	0.056	0.088	0.080	0.072
55-59	0.036	0.066	0.054	0.033
60-64	0.017	0.004	0.012	
Total	0.453	0.547	0.557	0.443
Weighted average age	41	42	42	41

The age bands relate to the age last birthday at the end of the financial year. However, for consistency with other ages shown in this report, the average figures are for ages at the start of the financial year.

Appendix E

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

Percentage of upper band earnings, with no cap

Age last birthday on last day of preceding tax year	Tax year 2007-08	2008-09	2009-10	2010-11	2011-12
15	3.0%	3.0%	3.0%	3.0%	3.0%
16	3.0%	3.0%	3.0%	3.0%	3.0%
17	3.1%	3.1%	3.1%	3.1%	3.1%
18	3.2%	3.2%	3.2%	3.2%	3.2%
19	3.3%	3.3%	3.3%	3.3%	3.3%
20	3.4%	3.4%	3.4%	3.4%	3.4%
21	3.4%	3.4%	3.4%	3.4%	3.4%
22	3.5%	3.5%	3.5%	3.5%	3.5%
23	3.6%	3.6%	3.6%	3.6%	3.6%
24	3.7%	3.7%	3.7%	3.7%	3.7%
25	3.8%	3.8%	3.8%	3.8%	3.8%
26	3.9%	3.9%	3.9%	3.9%	3.9%
27	4.0%	4.0%	4.0%	4.0%	4.0%
28	4.1%	4.1%	4.1%	4.1%	4.1%
29	4.1%	4.2%	4.2%	4.2%	4.2%
30	4.2%	4.3%	4.3%	4.3%	4.3%
31	4.3%	4.4%	4.4%	4.4%	4.4%
32	4.5%	4.5%	4.5%	4.5%	4.5%
33	4.6%	4.6%	4.6%	4.6%	4.6%
34	4.7%	4.7%	4.7%	4.7%	4.7%
35	4.8%	4.8%	4.8%	4.8%	4.8%
36	5.0%	5.0%	5.0%	5.0%	5.0%
37	5.1%	5.1%	5.1%	5.1%	5.2%
38	5.3%	5.3%	5.3%	5.3%	5.3%
39	5.5%	5.5%	5.5%	5.5%	5.5%
40	5.6%	5.6%	5.6%	5.6%	5.6%
41	5.8%	5.8%	5.8%	5.8%	5.8%
42	5.9%	5.9%	6.0%	6.0%	6.0%
43	6.1%	6.1%	6.1%	6.1%	6.1%
44	6.3%	6.3%	6.3%	6.3%	6.3%
45	6.6%	6.4%	6.4%	6.5%	6.5%
46	6.9%	6.7%	6.6%	6.6%	6.6%
47	7.2%	7.1%	6.9%	6.8%	6.8%
48	7.5%	7.4%	7.2%	7.1%	7.0%
49	7.9%	7.7%	7.6%	7.4%	7.3%
50	8.3%	8.1%	7.9%	7.8%	7.6%
51	8.7%	8.5%	8.3%	8.2%	8.0%
52	9.6%	8.9%	8.7%	8.6%	8.4%
53	10.8%	9.8%	9.2%	9.0%	8.8%
54	12.1%	11.0%	10.1%	9.4%	9.2%
55	13.5%	12.3%	11.2%	10.3%	9.6%
56	15.1%	13.7%	12.5%	11.4%	10.5%
57	16.0%	15.3%	13.9%	12.7%	11.6%
58	17.2%	16.3%	15.5%	14.2%	12.9%
59	12.5%	12.2%	11.9%	15.3%	14.3%
60	13.1%	12.7%	12.4%	12.1%	11.8%
61	13.7%	13.3%	12.9%	12.6%	12.2%
62	14.2%	13.8%	13.4%	13.1%	12.7%
63	15.2%	14.4%	14.0%	13.6%	13.2%

Appendix F

Contracted-out rebates proposed for members of appropriate personal pension schemes

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

Age last birthday on last day of preceding tax year	Tax year 2007-08	2008-09	2009-10	2010-11	2011-12
15	4.7%	4.7%	4.7%	4.7%	4.7%
16	4.7%	4.7%	4.7%	4.7%	4.7%
17	4.8%	4.8%	4.8%	4.8%	4.8%
18	4.9%	4.9%	4.9%	4.9%	4.9%
19	4.9%	4.9%	4.9%	4.9%	5.0%
20	5.0%	5.0%	5.0%	5.0%	5.0%
21	5.1%	5.1%	5.1%	5.1%	5.1%
22	5.2%	5.2%	5.2%	5.2%	5.2%
23	5.2%	5.2%	5.2%	5.2%	5.2%
24	5.3%	5.3%	5.3%	5.3%	5.3%
25	5.4%	5.4%	5.4%	5.4%	5.4%
26	5.5%	5.5%	5.5%	5.5%	5.5%
27	5.5%	5.5%	5.6%	5.6%	5.6%
28	5.6%	5.6%	5.6%	5.6%	5.6%
29	5.7%	5.7%	5.7%	5.7%	5.7%
30	5.8%	5.8%	5.8%	5.8%	5.8%
31	5.9%	5.9%	5.9%	5.9%	5.9%
32	6.0%	6.0%	6.0%	6.0%	6.0%
33	6.0%	6.0%	6.0%	6.1%	6.1%
34	6.1%	6.1%	6.1%	6.1%	6.1%
35	6.3%	6.3%	6.3%	6.3%	6.3%
36	6.4%	6.4%	6.4%	6.4%	6.4%
37	6.5%	6.6%	6.6%	6.6%	6.6%
38	6.7%	6.7%	6.7%	6.7%	6.7%
39	6.8%	6.8%	6.8%	6.8%	6.9%
40	7.0%	7.0%	7.0%	7.0%	7.0%
41	7.1%	7.1%	7.1%	7.1%	7.1%
42	7.2%	7.2%	7.2%	7.3%	7.3%
43	7.4%	7.4%	7.4%	7.4%	7.4%
44	7.5%	7.5%	7.5%	7.5%	7.5%
45	7.8%	7.6%	7.6%	7.6%	7.6%
46	8.1%	7.9%	7.7%	7.8%	7.8%
47	8.4%	8.2%	8.0%	7.9%	7.9%
48	8.7%	8.5%	8.3%	8.2%	8.0%
49	9.0%	8.8%	8.6%	8.4%	8.3%
50	9.4%	9.2%	9.0%	8.8%	8.6%
51	9.7%	9.5%	9.3%	9.1%	8.9%
52	10.5%	9.9%	9.7%	9.5%	9.3%
53	11.6%	10.7%	10.0%	9.8%	9.6%
54	12.7%	11.7%	10.8%	10.2%	10.0%
55	14.0%	12.9%	11.9%	11.0%	10.3%
56	15.3%	14.1%	13.0%	12.0%	11.1%
57	16.1%	15.4%	14.2%	13.1%	12.1%
58	17.1%	16.2%	15.5%	14.2%	13.1%
59	13.0%	12.6%	12.3%	15.2%	14.3%
60	13.4%	13.1%	12.7%	12.4%	12.1%
61	13.9%	13.5%	13.1%	12.8%	12.4%
62	14.3%	13.9%	13.5%	13.1%	12.8%
63	15.1%	14.3%	13.9%	13.5%	13.1%

OCCUPATIONAL AND PERSONAL PENSION SCHEMES

REVIEW OF CERTAIN CONTRACTING-OUT TERMS

Report by the Secretary of State for Work and Pensions in accordance with Sections 42(1)(b), 42B(1)(b) and 45A(1)(b) of the Pension Schemes Act 1993

Presented to Parliament by the Secretary of State for Work and Pensions by Command of Her Majesty
March 2006

Report by the Secretary of State for Work and Pensions in accordance with Sections 42(1)(b), 42B(1)(b) and 45A(1)(b) of the Pension Schemes Act 1993

As required by the Pension Schemes Act 1993, I am laying before Parliament my report on the reduced rates and rebates of National Insurance contributions to be allowed in respect of members of contracted-out occupational pension schemes and appropriate personal pension schemes.

This report, the accompanying draft Order and the Government Actuary's report deal with the reduced rates and rebates which will have effect from 6 April 2007, and which may continue to apply up to April 2012. However, the Pensions Commission, in its report "A New Pensions Settlement for the Twenty-First Century" has made a series of recommendations on the future of contracting out and the Government will be bringing forward its proposals in a White Paper in the Spring. Subject to that response, a further review of the reduced rates and rebates of National Insurance contributions may be conducted earlier than would otherwise be necessary.

Rebates reflect the fact that contracted-out occupational pension schemes and appropriate personal pension schemes provide an alternative to the State Second Pension, relieving the State of part of the liability to provide income in retirement.

The State Second Pension provides higher benefits for certain earners than the State Earnings Related Pension Scheme (SERPS) that applied up to April 2002. In particular, under the State Second Pension, low and moderate earners (for 2005/06 those earning between the annual lower earnings limit of £4,264 and the upper earnings threshold of £27,800 a year) build up more pension entitlement than they would have done under SERPS. In addition, low earners (those earning more than the annual lower earnings limit of £4,264 but less than the low earnings threshold, £12,100 a year in 2005/06) are treated for State Second Pension purposes as if they had earned at the level of the low earnings threshold.

Similarly, this extra help for low and moderate earners is also available to those who contract out of the state scheme:-

- Those in an appropriate personal pension scheme earning less than the low earnings threshold, receive a State Second Pension top-up that reflects the boost for low earners who are not contracted out. For those earning between the low and upper earnings thresholds, all the extra help is given through enhanced earnings related rebates.

- For those in occupational pension schemes, the top-up is delivered through the State Second Pension. In these cases, the rebate is calculated in the same way as it was previously calculated under SERPS. This avoided the need for employers to make changes to their payroll systems to reflect the State Second Pension.

The legislative provisions on stakeholder pensions allow different rebates to be set where contracted-out money purchase schemes or appropriate personal pension schemes are stakeholder schemes. I considered whether it was appropriate to have different rebates for stakeholder pension schemes but decided that, because there is evidence that the charges for the two types of scheme have tended to converge, it would not be appropriate to set the rebate at different levels. The Government Actuary has reported on the same basis for all contracted-out money purchase schemes and for all appropriate personal pensions, regardless of whether or not they are stakeholder pension schemes.

(1) Pension Schemes Act 1993 Section 42(1)(b)
Reduced rate of Class 1 National Insurance contributions for members of salary related contracted-our schemes

The first part of my report, required by Section 42(1)(b) of the Pension Schemes Act 1993 (as amended by Section 137(4) of the Pensions Act 1995) concerns the amount of the flat-rate rebate payable to those in contracted-out salary related schemes. Currently, Section 41(1A) and (1B) of the Pension Schemes Act 1993 (which incorporates the percentage rebates from the last Rebate Order, The Social Security (Reduced Rates of Class 1 Contributions) (Salary Related Contracted-out Schemes) Order 2001 (S.I. 2001/1356)) provides for a reduction in the combined primary and secondary Class 1 contributions by a total of 5.1% of the relevant earnings (split as 1.6% primary (employee) and 3.5% secondary (employer)). The relevant earnings are those between the lower and upper earnings limits.

The Government Actuary has reviewed the cost of providing benefits of an actuarial value equivalent to the amount of State Second Pension foregone by those in contracted-out salary related schemes. As mentioned above, this amount is equivalent to the amount of SERPS that would have been given up if additional pension had continued to be calculated on the basis of SERPS.

The Government Actuary has recommended that the contracted-out rebate should be set at 5.8% of relevant earnings. I have considered the Government Actuary's report, including the points made about the allowance for returns on investments, increasing longevity and the changes in membership of contracted-out salary related schemes (in particular more female members). However, in the present fiscal circumstances and given the current consideration of pensions policy outlined in the second paragraph to this report, I do not believe it would be appropriate to accept his recommendation. I have therefore decided to increase the reduction in the rate of National Insurance contributions to 5.3% of relevant earnings. I propose to maintain the reduction in the level of the primary contribution at 1.6% and to increase the reduction in the secondary contribution to 3.7%.

(2) Pension Schemes Act 1993 section 42B(1)(b)
Determination and alteration of reduced rates of contributions and rebates for members of money purchase contracted-out schemes applicable under Section 42A of that Act

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

The Government Actuary's report sets out, by reference to the age of the individual, the percentage of relevant earnings which he considers reflects the cost of providing benefits of an actuarial value equivalent to the State Second Pension foregone. The percentage is delivered in two parts – a flat-rate element (which takes the form of a reduction in Class 1 National Insurance contributions) and an age-related rebate paid to the scheme after the end of the tax year to which it relates.

In line with the Government Actuary's report, I have decided to increase the flat-rate element for contracted-out money purchase schemes to 3.0% of relevant earnings for members of contracted-out money purchase schemes. I propose to split the flat-rate rebate between the primary contribution at 1.6% and the secondary contribution at 1.4%. I have also decided to increase the level of the age-related element of the rebate as the Government Actuary recommends. However, I have also concluded that the rebates should continue to be subject to a cap. The current level of this cap is 10.5% of relevant earnings. I have now decided to change this to 7.4%, taking account of fiscal constraints and given, again, the current consideration of pensions policy outlined in the second paragraph to this report. Although I recognise that setting the cap at this level would affect some of those at ages below those currently affected by the cap, and reduce the rebate some people currently receive, I believe the considerations I have mentioned above are sufficiently persuasive to justify the change.

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

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

As for members of contracted-out money purchase schemes, the Government Actuary's report sets out, by reference to the age of the individual, the percentage of relevant earnings which he considers reflects the cost of providing benefits of an actuarial value equivalent to the State Second Pension foregone.

I have decided to increase the age-related rebates for holders of appropriate personal pensions in line with the Government Actuary's report. However, as with contracted-out money purchase schemes, these age-related rebates are subject to a cap, currently set at 10.5%. For the reasons given in relation to contracted-out money purchase schemes, I have decided to change the cap for appropriate personal pensions and set it too at 7.4%. Again, I recognise that setting the cap at this level would affect some of those at ages below those currently affected by the cap and reduce the rebate some people currently receive.

Revaluation of Guaranteed Minimum Pensions

I propose also that the percentage rate by which guaranteed minimum pensions are to be revalued for those who leave pensionable service before normal pension age (currently 4.5% a year compound for those leaving since April 2002) should be changed to 4.0% a year compound for those who leave on or after 6 April 2007. This is in line with the Government Actuary's recommendations. An amendment to the existing regulation will be introduced in due course to provide for this.

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