National Audit Office

Report
by the Comptroller
and Auditor General

Department for Work & Pensions

The impact of state pension reforms on people with Guaranteed Minimum Pensions

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Summary

1 On 6 April 2016 the government will introduce the new state pension. The Department for Work & Pensions (the Department) estimates that more than 2 million people will reach state pension age in the next five years, of whom up to 900,000 have a Guaranteed Minimum Pension. The introduction of the new state pension, along with the government's changes to state pension age, will affect all people with Guaranteed Minimum Pensions.

2 The existing state pension is made up of two elements: the basic state pension and additional state pension. Since 1978, occupational pension scheme providers have been able to 'contract out' of the additional state pension. Under these arrangements, employers and employees pay a reduced rate of National Insurance. In return, employees forgo their entitlement to additional state pension. Instead, pension scheme providers have to provide a minimum level of pension to replace this.

3 The government introduced contracting-out arrangements so that people who were members of defined benefit pension schemes were not also required to save into the earnings-related additional state pension. For individuals who were in contracted-out defined benefit pension schemes between 1978 and 1997, scheme providers have to provide a Guaranteed Minimum Pension.[1] When contracting-out was introduced in 1978, the government's basic principle was that these individuals should not be any worse off as a result of having been a member of a contracted-out scheme.

4 The changes in April 2016 will end contracting out and introduce a new flat-rate state pension for everyone retiring after this date. Several members of the public have contacted us to express concerns about the implications for Guaranteed Minimum Pensions of introducing the new state pension. In particular, correspondents are concerned that people with Guaranteed Minimum Pensions will be worse off, and that the Department has not given sufficient warning to people who will be affected.

5 We have examined these concerns in this report, which:

- describes how Guaranteed Minimum Pensions work under existing pension arrangements (Part One);
- explains how Guaranteed Minimum Pensions will work under new state pension arrangements (Part Two);
- reviews the consequences of these changes for people with Guaranteed Minimum Pensions (Part Three); and
- considers the Department's assessment and communication of these changes (Part Four).

1 The main technical terms used in this report are defined in Appendix Two.

6 This report assesses a complicated area of pension reform. It reviews the Department's approach to assessing and communicating the changes to Guaranteed Minimum Pensions resulting from the introduction of the new state pension. While it does illustrate how people might be affected by pension reforms, it is not intended as guidance and does not provide advice to individuals on their specific circumstances. Neither do we seek to assess the value for money of pension reforms or Guaranteed Minimum Pensions. We are planning further work to review wider pension reforms.

Key findings

Guaranteed Minimum Pensions under existing pension rules

7 Pension scheme providers are responsible for paying Guaranteed Minimum Pensions. The Guaranteed Minimum Pensions of people who were in contracted-out defined benefit pension schemes between 1978 and 1997 should be broadly equivalent to the additional state pension that they would otherwise have received. Instead of the additional state pension, these people receive an occupational pension which must meet a statutory minimum rate. Individuals and employers who contracted out of the state pension will have paid lower rates of National Insurance (paragraphs 1.4, 1.5 and 1.19).

8 In effect, the government currently pays for some of the annual inflation increases to Guaranteed Minimum Pensions. Under existing rules, pension scheme providers uprate Guaranteed Minimum Pensions accrued between 1988 and 1997 up to a maximum of 3% per year. The Department then recalculates the state pension payable each year, which makes sure that a person's Guaranteed Minimum Pension entitlement is uprated. While the Department does not make any payments directly towards Guaranteed Minimum Pensions, it bears some of the costs of uprating and so, in effect, pays for a share of inflation increases (paragraphs 1.21 to 1.23).

Guaranteed Minimum Pensions after state pension reforms

9 The new state pension ends contracting out. From April 2016 the government will replace the basic and additional state pensions with a new single state pension. Employers will no longer be able to contract their pension schemes out of the state pension scheme. Working-age people will have their existing state pension entitlement adjusted for previous periods of contracting out and transferred to the new state pension scheme. Occupational pension scheme providers will continue to revalue any Guaranteed Minimum Pensions that people have built up (paragraphs 2.6 to 2.11).

10 **For people retiring after 6 April 2016, the government will no longer take account of inflation increases to Guaranteed Minimum Pensions when uprating people's new state pension.** Scheme providers will continue to uprate occupational pensions – including part of Guaranteed Minimum Pensions – in accordance with scheme rules and statutory requirements. The changes mean any Guaranteed Minimum Pensions that people have accrued between 1978 and 1988 will not be uprated, and the scheme provider will only uprate Guaranteed Minimum Pensions built up between 1988 and 1997 to a maximum of 3% each year. People who have already started claiming their state pension will be unaffected (paragraphs 2.19 to 2.21).

How people may be affected by reforms

11 **The increases in state pension age means that Guaranteed Minimum Pensions could lose more value before people draw their state pension.** Since 2010 the state pension age has been increasing but the Guaranteed Minimum Pension age will remain at 60 for women and 65 for men. This means there could be a longer period in which Guaranteed Minimum Pensions are not uprated fully before the individual receives their state pension (paragraphs 3.4 to 3.6).

12 **Guaranteed Minimum Pensions will lose value under the new rules but people may be able to build up additional entitlement to new state pension.** As people are able to build up higher amounts of new state pension (compared with the existing basic state pension), they may be better off overall, or at least offset some of the loss to the value of their Guaranteed Minimum Pension. The amount by which individuals will be affected will depend on the time they were in a contracted-out scheme, the value of their new state pension, how the government decides to uprate the state pension and future inflation rates (paragraphs 3.8 to 3.12).

13 **The impact of new state pension reforms on people with Guaranteed Minimum Pensions will vary widely.** The type of person who will do comparatively worse under the reforms is someone who has spent long periods in a contracted-out pension scheme and is close to retirement on 6 April 2016, so has little time to build up additional entitlement to new state pension. The Department estimates that 180,000 people who will reach state pension age in 2016-17 will have Guaranteed Minimum Pensions from before 1988. The amount by which people will be affected depends on their specific employment history. The Department's modelling forecasts that 50,000 of these people will be worse off in 2017-18 as a result of the introduction of new state pension (paragraphs 3.13 to 3.17).

The Department's assessment and communication of changes

14 **The Department's baseline information about the impact of pension reforms on people with Guaranteed Minimum Pensions is limited.** In January 2016 the Department modelled how people in contracted-out pension schemes could lose out, using hypothetical information to test the impact of pension reforms. The Department has not, however, used information on people's actual circumstances to establish how individuals with Guaranteed Minimum Pensions might be affected. In addition, it does not know what proportion of state pension payments relates to its share of uprating Guaranteed Minimum Pensions. The Department has not previously had a business need to calculate this or collate information on individuals' Guaranteed Minimum Pensions (paragraphs 4.3 to 4.5).

15 **There has been a lack of clear information for people with Guaranteed Minimum Pensions.** While the Department has issued factsheets on the new state pension, it has provided limited details on the circumstances in which people with Guaranteed Minimum Pensions could end up worse off under the new arrangements. It believes it could be misleading to show people how they might be affected by one aspect of pension reforms in isolation, without considering the combined impact of changes. The Department has not therefore provided information directly to people with Guaranteed Minimum Pensions about their overall state pension income (paragraphs 4.6 to 4.9).

16 **The Department is now increasing its communication of new state pension reforms.** Its campaign targets people aged 50 plus and includes a state pension toolkit and the offer of personal statements. The Department is continuing to revise the content and presentation of personal pension statements, including more information about the implications of contracting out (paragraphs 4.10 and 4.11).

Concluding remarks

17 The uprating of Guaranteed Minimum Pensions is a complicated area. The impact of reforms on individuals will depend on a number of factors including their age, employment history, earnings and future inflation. Some people are likely to lose out and they have not been able to find the information they need.

18 We are concerned that the Department has limited information about who is affected by the impact of pension reforms on Guaranteed Minimum Pensions. It is now seeking to improve how it communicates the impact of pension reforms, and will need to help people identify how they are affected and provide them with accurate and more complete information so that they can make informed decisions about their future pension arrangements.