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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Department for Work & Pensions

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

Report by the Comptroller and Auditor General

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Comptroller and Auditor General
National Audit Office

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This report reviews the Department's approach to assessing and communicating the changes to Guaranteed Minimum Pensions resulting from the introduction of the new state pension.

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Contents

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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.

Part One

Guaranteed Minimum Pensions – before April 2016

1.1 This Part explains how Guaranteed Minimum Pensions work under existing state pension rules until 5 April 2016. It covers:

- the rationale for Guaranteed Minimum Pensions;
- how entitlement has been built up;
- how Guaranteed Minimum Pensions are calculated; and
- current arrangements for uprating Guaranteed Minimum Pensions once they are in payment.

The rationale for Guaranteed Minimum Pensions

1.2 Guaranteed Minimum Pensions were introduced to ensure that, on retirement, people who were in defined benefit contracted-out occupational pension schemes are not any worse off as a result. To understand how they work, it is necessary to set out the different types of pension.

1.3 A person can claim state pension when he or she reaches the state pension age.[2] The existing state pension is made up of two elements:

- the basic state pension, which is based on number of years in which a person has paid National Insurance contributions. In 2015-16, the maximum basic state pension is £6,029 per year (£115.95 per week); and
- an additional state pension, which is earnings-related and based on the amount of National Insurance contributions a person has paid. In 2015-16, the maximum additional state pension is around £8,600 per year (around £165 per week).

2 For people retiring in 2015-16, this is 65 years for men, and for women it ranges between 62 years 6 months and 63 years, depending on their date of birth.

1.4 People can also build up further pension entitlement – alongside the state pension – through occupational pension schemes provided by their employers, or by investing in private pensions.

1.5 Since 1978 providers of defined benefit occupational pension schemes in the public and private sector have been able to 'contract out' of the additional state pension.[3] Under contracting-out arrangements, employers and employees pay a reduced rate of National Insurance. In return, employees forgo their entitlement to additional state pension, and the pension scheme provider has to provide a minimum level of benefit to replace this.

1.6 For people who were in defined benefit contracted-out pension schemes between 1978 and 1997, scheme providers have to provide Guaranteed Minimum Pensions. The value of the Guaranteed Minimum Pension is intended to be broadly equivalent to the additional state pension that the person would otherwise have received.

1.7 Providers of contracted-out schemes have not been required to provide Guaranteed Minimum Pensions since 6 April 1997. Instead, government has required scheme providers to meet an overall test of scheme quality, known as the 'reference scheme test', in order to contract out of the additional state pension.[4]

1.8 Guaranteed Minimum Pensions will, however, affect people's pension payments long into the future because members of contracted-out schemes retain the right to any Guaranteed Minimum Pensions they have earned. Some people with rights to Guaranteed Minimum Pensions may not reach state pension age until around 2050, at which date the Department for Work & Pensions (the Department) estimates at least one-in-ten pensioners will have been contracted out at some point.

1.9 **Figure 1** overleaf provides an overview of current pension arrangements for people who have been in contracted-out defined benefit pension schemes. It considers how pension entitlement is built up, calculated and uprated.

People can build up their entitlement to different types of pension

1.10 People's entitlement to basic state pension is based on their qualifying years of National Insurance contributions, up to a maximum of 30 years. No minimum number of qualifying years is required to qualify for some basic state pension. People can also build up additional state pension, depending on their earnings and, where applicable, credits given to people on certain benefits.

3 The ability to contract out of the additional state pension was extended to defined contribution schemes in 1988. For members of such schemes, the pension payment from the scheme provider replaces the additional state pension. These schemes do not have to provide Guaranteed Minimum Pensions. The option to contract out through a defined contribution scheme ended in April 2012.

4 To pass the reference scheme test, schemes have to offer certain benefits, including an occupational pension equal to at least 1/80th of salary multiplied by number of years of service, and that half-pensions are provided to surviving spouses.

Figure 1

Overview of pension arrangements for people who have been in contracted-out pension schemes – before April 2016

Contracted-out schemes must provide a minimum level of benefits in return for paying reduced National Insurance

	Main elements of the existing state pension	For people who have contracted out
Building up pension entitlement – before state pension age	Individuals build up entitlement to state pension: • Basic state pension – based on number of years of National Insurance contributions, up to a maximum of 30 years. • Additional state pension – amount payable depends on earnings. They can also build up further pension entitlement using occupational or private pensions.	Employers and employees pay a reduced National Insurance contribution: • In return, the employee forgoes the right to some or all additional state pension. • But the scheme provider must provide an equivalent level of benefits – a Guaranteed Minimum Pension for any service between 1978 and 1997. For people who leave the occupational scheme before pensionable age: • the scheme provider must revalue the individual's entitlement, including the Guaranteed Minimum Pension, up to the Guaranteed Minimum Pension age (60 for women and 65 for men).
Calculation of entitlement – at state pension age	Each individual's entitlement to state pension is calculated: • The government pays basic state pension plus any additional state pension – depending on the individual's employment history. Individuals can also receive payments from other pension schemes that they may have: • The level of payment depends on scheme rules – but will include the Guaranteed Minimum Pension.	An individual's state pension takes account of periods that they have been contracted out: • the Guaranteed Minimum Pension is based on the periods contracted out between 1978 and 1997; and • the additional state pension is reduced to reflect the value of the Guaranteed Minimum Pension.
Uprating pension payments – after state pension age	State pension payments are uprated each year: • The basic state pension is currently protected by the triple lock.[1] The additional state pension is uprated in line with the Consumer Price Index (CPI).	The Government uprates the state pension and scheme providers uprate occupational pensions: • The level of uprating depends on inflation and the individual's employment history. • The government recalculates the amount of additional state pension payable each year – taking account of the value of the uprated Guaranteed Minimum Pension. • The scheme provider uprates the pension payment after recalculation of the Guaranteed Minimum Pension.

Note

1 For the current Parliament, the government has committed to uprating the basic state pension by the triple lock. This means that the basic state pension is increased by the higher of price inflation, earnings growth or 2.5%.

Source: National Audit Office

1.11 Members of contracted-out occupational pension schemes forgo some or all of the additional state pension. The pension scheme provider determines the scheme's rules, but it must meet minimum statutory requirements. This includes an obligation to provide Guaranteed Minimum Pensions for service built up between 1978 and 1997. The aim of Guaranteed Minimum Pensions is that members of contracted-out schemes should receive pensions that are broadly equivalent to what they would have received had they not contracted out.

1.12 A person may leave a contracted-out occupational pension scheme before they start drawing their pension. In these cases, if pension rights are preserved, the scheme provider is responsible for revaluing the Guaranteed Minimum Pension each year until the person reaches the Guaranteed Minimum Pension age (60 for women, and 65 for men).[5]

1.13 A scheme provider may allow a person to start drawing their occupational pension before they reach the Guaranteed Minimum Pension age. If they do, the scheme provider is responsible for revaluing the pension each year, by average earnings or a fixed rate, until the Guaranteed Minimum Pension age is reached.

Women's Guaranteed Minimum Pension age is now lower than the State Pension age

1.14 A person's Guaranteed Minimum Pension is calculated when they reach state pension age. The pension scheme provider can request a calculation from HM Revenue & Customs (HMRC) and agree what the Guaranteed Minimum Pension should be, once they have resolved any queries by reconciling their records of the member's earnings and National Insurance contributions paid between 1978 and 1997.

1.15 Since 2010 the Guaranteed Minimum Pension age (60 for women and 65 for men) is lower than the state pension age for women born after 6 April 1950.[6] In such circumstances, once a woman reaches the Guaranteed Minimum Pension age, the scheme provider is only obliged to uprate the occupational pension in accordance with the statutory requirement, as follows:

- Guaranteed Minimum Pensions accrued between 6 April 1978 and 5 April 1988 will not be uprated;
- Guaranteed Minimum Pensions accrued between 6 April 1988 and 5 April 1997 are uprated by Consumer Price Index (CPI), capped at 3%;
- the total pension accrued between 6 April 1997 and 5 April 2005 is uprated by CPI, capped at 5%; and
- the total pension accrued from 6 April 2005 is uprated by CPI capped at 2.5%.

5 The scheme provider can choose one of three revaluation methods: the increase in average national earnings; a fixed rate (the rate is determined according to when the member left the scheme, and rates are reviewed every 5 years); or limited rate revaluation, which is the lower of 5% or the increase in earnings growth (this option is only available when a person left the contracted-out scheme before 6 April 1997 and required a payment of a premium by the pension scheme to the National Insurance Fund to compensate for the lower increases the scheme would be required to pay).

6 This is because the equalisation of state pension age at 65 for both men and women started in May 2010, since when the state pension age for women has been higher than the Guaranteed Minimum Pension age, which has remained at 60 years.

1.16 The scheme rules might require the provider to uprate the occupational pension by more than the statutory minimum. However, the government does not provide any additional inflationary uprating before a person reaches state pension age.

Guaranteed Minimum Pensions affect the calculation of the state pension

1.17 On reaching state pension age, the Department calculates each person's entitlement to state pension. The amount of basic state pension is based on the person's qualifying years of National Insurance contributions. The Department also determines whether any additional state pension is payable. For people who have been in a contracted-out scheme, the additional state pension entitlement is reduced by a 'contracted-out deduction' which reflects the value of the Guaranteed Minimum Pension.[7]

1.18 Guaranteed Minimum Pensions are not a separate payment by the government (**Figure 2**). They are paid by the pension scheme provider as part of the person's occupational pension.

1.19 Employers and employees who have contracted out have paid lower National Insurance contributions. In exchange, private pension schemes must provide pensions which meet minimum statutory standards to replace the additional state pension that the person would otherwise have been entitled to. In effect, pension providers are paying the additional state pension that the person would have got if they had not contracted out.

The government's uprating helps protect the value of Guaranteed Minimum Pensions

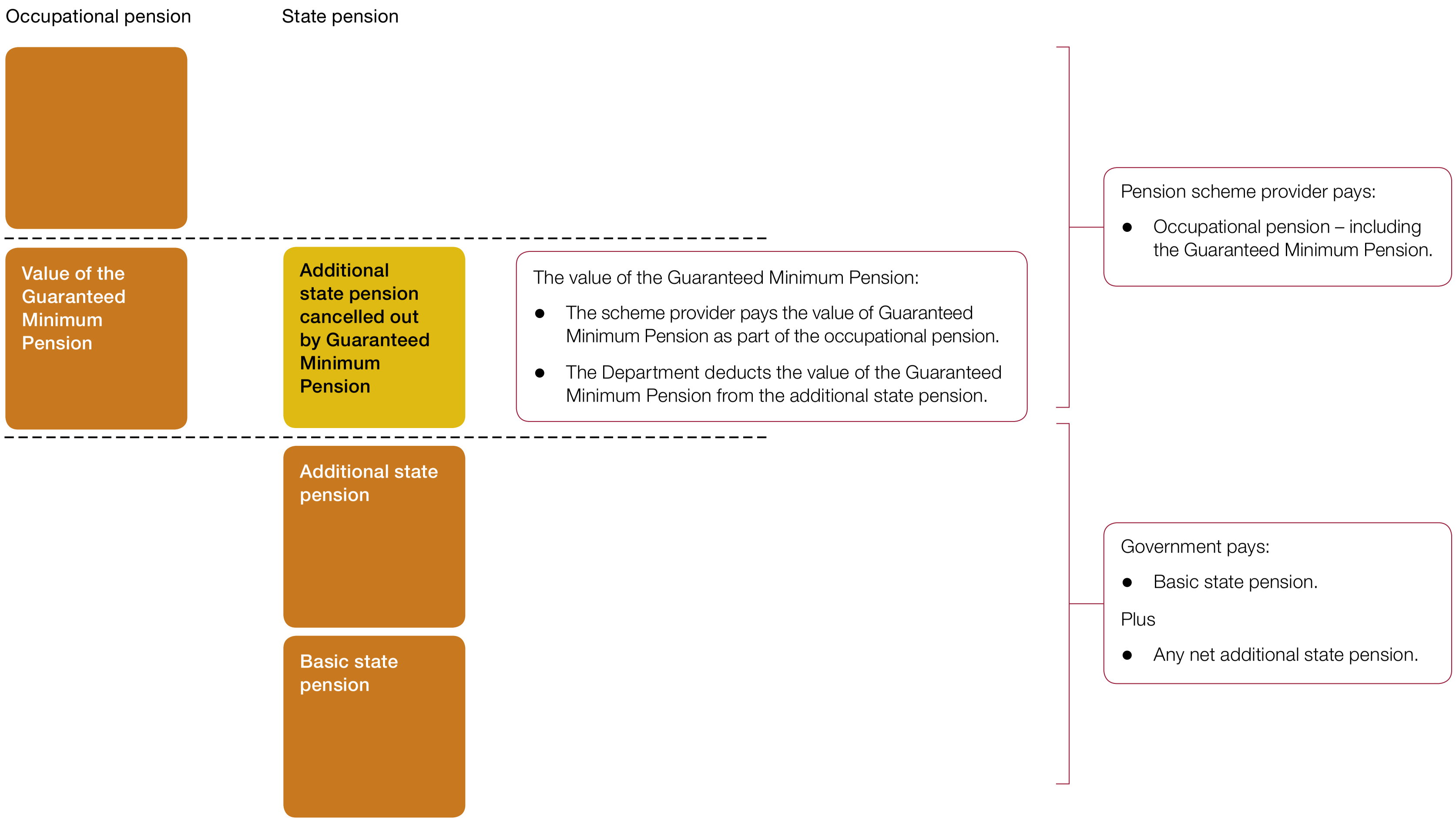
1.20 The government uprates the state pension each year according to the rate set by Parliament. Since April 2011, legislation provides that the basic state pension is uprated at least by earnings growth each year. For the current Parliament, the government has committed to uprating the basic state pension by the 'triple lock'. This means that the basic state pension is increased by the higher of price inflation, earnings growth or 2.5%. The additional state pension is uprated according to price inflation, which the government calculates using CPI.

7 The Department does this by calculating the amount of additional state pension the person would have accrued had they not been a member of a contracted-out scheme (the 'gross additional pension'). It then subtracts the value of the Guaranteed Minimum Pension (called the 'contracted-out deduction') from the gross additional pension, and pays any net amount as additional state pension. Because of fixed-rate revaluations (see para 1.12) the Guaranteed Minimum Pension can be significantly higher than the gross additional state pension, but it cannot affect the value of basic state pension or additional state pension that someone has built up after 1997.

Figure 2

How Guaranteed Minimum Pensions fit into the state pension

The additional state pension is reduced by the amount of Guaranteed Minimum Pension payable



Note

1 The figure is illustrative and intended to show how Guaranteed Minimum Pensions are factored into pension payments. The value of each person's entitlement will vary depending on their employment history.

Source: National Audit Office

1.21 In effect, the payment of the annual increases from uprating Guaranteed Minimum Pensions is split between pension scheme providers and the government:[8]

- the scheme provider is not required to uprate Guaranteed Minimum Pensions earned in respect of service up to 1988. The government in effect pays this increase by increasing the value of additional state pension payment; and
- for Guaranteed Minimum Pensions earned between 1988 and 1997, the scheme provider pays inflationary increases linked to CPI up to 3%. If the rate of increase is above 3%, any additional increase is paid by the government as part of the additional state pension.

1.22 The amount by which the value of Guaranteed Minimum Pensions is uprated each year is set by Parliament. The Department recalculates the amount of additional state pension that is payable each year.

1.23 Figure 3 illustrates how a person's pension would be uprated under current rules if CPI was 5%. We have used 5%, rather than the Office for Budget Responsibility's forecast inflation rate, in order to illustrate how the current rules work. This shows that, in effect, the government pays part of the uprating to Guaranteed Minimum Pensions through the state pension. In this example, this would be £70 of the £300 increase on the occupational pension. The government re-calculates the additional state pension to include the £50 inflationary increase on Guaranteed Minimum Pensions earned between 1978 and 1988, and the £20 inflationary increase above 3% for service between 1988 and 1997.

8 The Government's contribution to these increases is calculated by re-performing the calculation of additional state pension each year, having first uprated the gross additional pension by CPI. The government uprates all of the additional state pension built up to 1988 and adjusts this by the contracted-out deduction, which reflects the value of the Guaranteed Minimum Pension. Once the contracted out deduction has been subtracted from the uprated gross additional pension, the government pays the net amount as part of the additional state pension. This calculation ensures that a person will not receive an increase if the value of their Guaranteed Minimum Pension is greater than the total additional State Pension they would have received had they not been contracted out.

Figure 3

Example of uprating of pensions before 6 April 2016

The government pays additional state pension which, in effect, provides for some of the inflation increase for Guaranteed Minimum Pensions

The person:

- reaches state pension age before 6 April 2016, so the current pension rules apply;
- has 30 qualifying years for the basic state pension, so receives the maximum amount;
- has paid contracted-out National Insurance throughout and does not qualify for any additional state pension on reaching state pension age;
- started work in the late 1970s, so has built up a Guaranteed Minimum Pension that relates to earnings both before and after 6 April 1988; and
- has an occupational pension that exceeds the Guaranteed Minimum Pension, the balance of which is uprated at the notional 5% CPI rate used in this example.

Pension element	Initial amount	Increase paid by the scheme provider		Increase paid by the government		Total annual cash increase in first year	
	(£)	(%)	(£)	(%)	(£)	(%)	(£)
Basic state pension	**6,029**	–	–	5.0	301	**5.0**	**301**
Additional state pension	**–**	–	–	–	–	–	–
Occupational pension	**6,000**	3.8	230	1.2	70	**5.0**	**300**
Pre-1988 GMP	1,000	–	–	5.0	50	5.0	50
Post-1988 GMP	1,000	3.0	30	2.0	20	5.0	50
Occupational pension excluding GMP	4,000	5.0	200	–	–	5.0	200
Overall total	**12,029**	1.9	230	3.1	371	**5.0**	**601**

Notes

1 The government pays the £70 increase through the additional state pension.

2 The 5% inflation rate is used for illustrative purposes, in order to demonstrate how the current rules work.

Source: National Audit Office

Part Two

Guaranteed Minimum Pensions – after state pension reforms

2.1 Since 2010 the government has initiated pension reforms that will equalise the state pension age between men and women, raise the state pension age and introduce a new single-tier state pension from 6 April 2016. These changes will affect how Guaranteed Minimum Pensions are calculated and uprated. This part covers:

- the state pension reforms that will affect Guaranteed Minimum Pensions;
- how people will build up their pension entitlement under new pension rules;
- future responsibilities for calculating Guaranteed Minimum Pensions; and
- how Guaranteed Minimum Pensions will be uprated after 6 April 2016.

State pension reforms that will affect Guaranteed Minimum Pensions

2.2 In 1993 the government announced that state pension ages would be equalised at 65 for both men and women, over a 10-year period starting in 2010. In 2011, the timetable for this change was brought forward, so that the increase in women's state pension age to 65 would apply from November 2018.

2.3 In 2006 the government announced that the state pension age should be increased to "keep the increase in public expenditure within limits which are fair between generations and sustainable over the long term".[9] The legislation has been introduced in stages. In 2007 the government made provision to increase the state pension age from 66 to 68 between 2024 and 2046. In 2014 it brought forward the timetable to increase state pension age to 67, which will now happen between 2026 and 2028.

2.4 On 6 April 2016 the government will introduce the new state pension. Everyone reaching state pension age on or after 6 April 2016 (men born on or after 6 April 1951, and women born on or after 6 April 1953) will be subject to the new rules. The government's objectives are to "deliver a simpler and fairer state pension that provides a better foundation for saving and is sustainable for future generations".[10]

9 In 2005 the Pensions Commission, chaired by Lord Turner, published a report which recommended that the state pension age needed to increase. In 2006 the government published a White Paper, *Security in retirement: towards a new pensions system*, which accepted this proposal.

10 Department for Work & Pensions, *The single-tier pension: a simple foundation for saving*, Impact Assessment DWP0028, January 2013.

2.5 These reforms will affect people with Guaranteed Minimum Pensions. From 6 April 2016, contracting out will end and all employers and employees will pay the full rate of National Insurance. The reforms will end the additional state pension and entitlement to new state pension will be based solely on the number of qualifying years of National Insurance contributions. **Figure 4** summarises the main changes.

Figure 4

Overview of how pension reforms affect people in contracted-out schemes – after April 2016

The new state pension will remove the mechanism that government has used to help maintain the value of Guaranteed Minimum Pensions

	The introduction of the new state pension will mean	For people who have contracted out
Building up pension entitlement – before state pension age	The government will calculate everyone's entitlement as at 6 April 2016: • Comparing entitlement under old and new schemes – the higher amount will become the individual's 'starting amount'. Individuals can continue to build their entitlement to new state pension after April 2016: • People can add qualifying years of National Insurance contributions, up to the maximum.	Each individual's 'starting amount' will take account of any periods of contracting out. The value of the Guaranteed Minimum Pension will be revalued until the individual reaches the Guaranteed Minimum Pension age (65 for men; 60 for women): • Pension scheme providers will uprate accrued entitlement. • The government has determined statutory rules for uprating.
Calculation of entitlement – at state pension age	The Department will calculate entitlement – based on an individual's starting amount plus additional qualifying years: • 35 qualifying years of National Insurance contributions needed for the full rate of new state pension (in steady state); and • a minimum of 10 years is needed to receive any payment.	Individuals will receive a state pension from the government and any occupational or private pension from their scheme provider: • The occupational pension payment will equal or exceed the value of the Guaranteed Minimum Payment.
Uprating pension payments – after state pension age	The government will uprate the state pension each year: • at least in line with growth in average earnings; and • the increase will be set by Parliament each year.	Part – but not all – of the Guaranteed Minimum Pension will be uprated annually: • There are different rules for different periods of contracted-out service. • The scheme provider subtracts the value of the Guaranteed Minimum Pension from the total scheme payments and uprates the net amount in accordance with scheme rules.

Source: National Audit Office

The new state pension reforms change how people build up their pension entitlement

2.6 Entitlement to the new state pension will be based on the number of qualifying years of National Insurance contributions. A person will require 35 qualifying years to receive the full amount, up from the 30 years needed for the full rate of basic state pension. Entitlement will be calculated on a pro rata basis. People will qualify on the basis of their own National Insurance record and will need a minimum of 10 years to qualify for any new state pension. Their right to inherit the contributions of a former spouse or civil partner will end, subject to some transitionary arrangements.

2.7 In order to take account of a person's National Insurance contributions up to 5 April 2016, the government will calculate everyone's existing pension entitlement as at 6 April 2016, regardless of when they reach state pension age. This will be known as a person's 'starting amount', to which additional qualifying years can be added under new rules.

2.8 The government's aim is to ensure that – at the point of the transition – everyone's state pension entitlement is at least as much under new rules as they would have received under previous rules. To achieve this, the Department for Work & Pensions (the Department) will undertake two calculations. It will calculate each person's entitlement up to the end of the 2015-16 tax year using existing scheme rules, and then recalculate their entitlement using the new state pension rules. Each person's 'starting amount' will be the higher of the two amounts. Both calculations make a deduction to reflect periods when a person paid lower rates of National Insurance because they were in a contracted-out scheme.[11]

2.9 The starting amount becomes the basis on which individuals will build their state pension entitlement after 6 April 2016 under the new rules. People whose starting amount is less than the maximum new state pension rate can continue to build their entitlement by adding qualifying years of National Insurance contributions (at a rate of 1/35th of the full amount of new state pension for each year) up to the maximum rate.

2.10 If the starting amount exceeds the maximum new state pension rate, the excess will be protected (termed a 'protected payment'). The person will not be able to accrue any more new state pension entitlement.

2.11 Until a person reaches state pension age, the starting amount will be revalued each year in line with arrangements for revaluing the new state pension, up to the maximum value of the new state pension. If a person's starting amount exceeds the maximum new state pension, the 'protected payment' element will also be revalued, but in line with prices using CPI rather than using the triple lock.

11 This could result in some people receiving more under the new state pension than under existing rules. For example, Guaranteed Minimum Pensions will be crystallised on 6 April 2016 for people who have left a defined benefit contracted-out scheme early. This might result in their starting amount including some amount in respect of additional state pension. Under the current system their Guaranteed Minimum Pension would have been calculated at state pension age, by which stage their additional state pension could have been reduced further or completely extinguished (especially for those whose schemes used fixed-rate revaluations, which could be as high as 8.5%).

Scheme providers are responsible for calculating and revaluing Guaranteed Minimum Pensions

2.12 Under new state pension rules, the scheme provider is solely responsible for maintaining the records needed to calculate each member's Guaranteed Minimum Pension. Up to October 2018, scheme providers will reconcile their records with HM Revenue & Customs (HMRC) to establish their members' Guaranteed Minimum Pensions for periods up to 6 April 2016.[12] This will replace the current system, in which the reconciliation takes place at the point a person leaves the scheme, reaches Guaranteed Minimum Pension age (and requests a calculation) or reaches state pension age.

2.13 Scheme providers will revalue Guaranteed Minimum Pensions for people who remain in defined benefit schemes after 6 April 2016 by earnings growth. If a person leaves a scheme after contracting out has been abolished, but before they reach the scheme's pensionable age, the scheme provider can choose whether it revalues the Guaranteed Minimum Pension by earnings growth or by a fixed rate.

2.14 As with existing arrangements, it is possible for an individual to draw their occupational pension before they reach state pension age. The scheme provider will continue to revalue Guaranteed Minimum Pensions each year, by either earnings growth or a fixed rate, until the person reaches the Guaranteed Minimum Pension age.

2.15 As the state pension age is increasing, a gap will grow between the Guaranteed Minimum Pension age and state pension age. Whether a scheme provider fully uprates Guaranteed Minimum Pensions between the Guaranteed Minimum Pension age and state pension age will depend on the scheme's rules. The minimum statutory requirement, once someone reaches the Guaranteed Minimum Pension age, is that the scheme provider must uprate any Guaranteed Minimum Pensions accrued after 6 April 1988 by CPI capped at 3%. Scheme providers are not required to uprate Guaranteed Minimum Pensions that were accrued before 6 April 1988.

The government will no longer take account of Guaranteed Minimum Pensions when calculating the new state pension

2.16 On drawing the new state pension, each person's entitlement will be calculated by adding their starting amount to any additional qualifying years built up since April 2016. A person must have at least 10 qualifying years to receive any new state pension, and will require 35 qualifying years to receive the full amount.[13] In November 2015 the government announced that the maximum annual new state pension in 2016-17 would be £8,093.80 (£155.65 per week).

12 To help this reconciliation process, HMRC is developing an on-demand, self-serve Guaranteed Minimum Pension calculation service for scheme administrators.

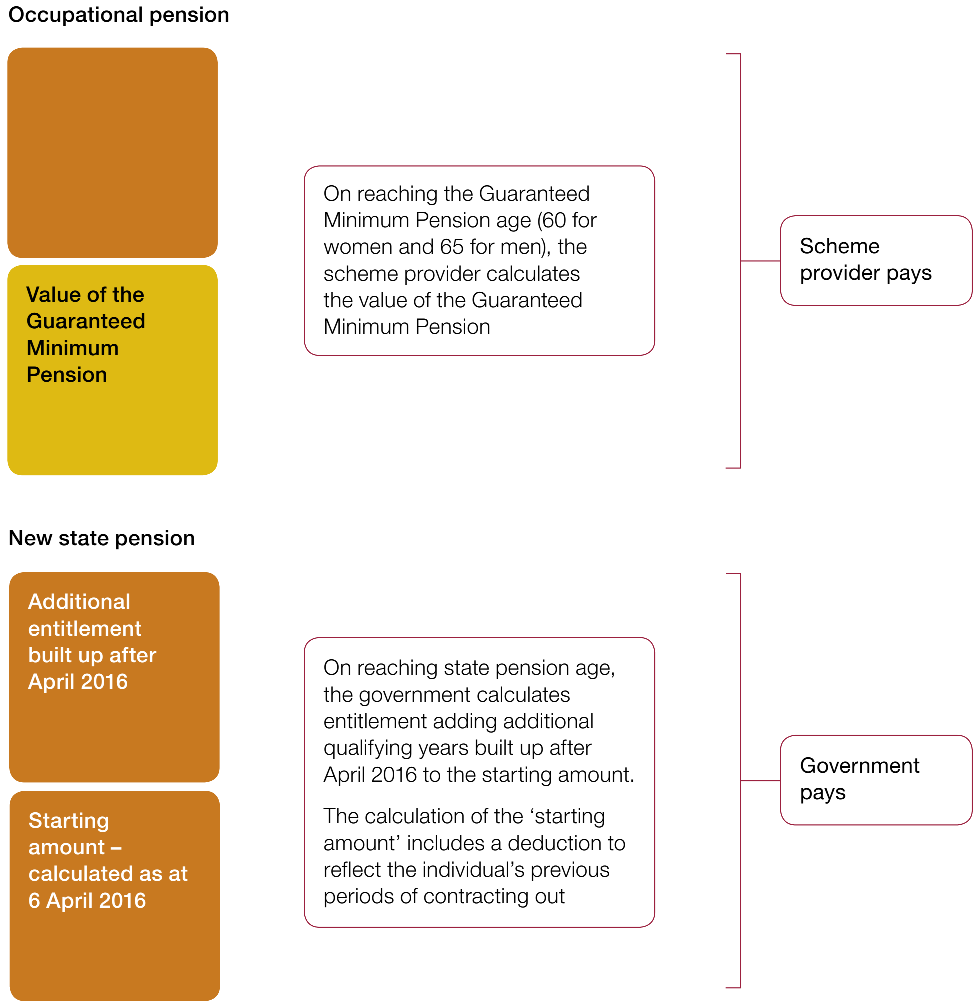
13 For anyone with a pre-2016 National Insurance record, there are no conditions about maximum qualifying years. People whose starting amount is below the maximum new state pension will be able to build up their entitlement to the maximum amount. People whose starting amount is greater than the maximum new state pension will have the greater amount protected.

2.17 As with existing arrangements, Guaranteed Minimum Pensions are not separate payments. The scheme provider pays the occupational pension, which must equal or exceed the value of the Guaranteed Minimum Pension (**Figure 5**). The Department will no longer need to know the value of Guaranteed Minimum Pensions to calculate the person's new state pension entitlement as it will have already been factored into the starting amount.

Figure 5

How Guaranteed Minimum Pensions will form part of pension payments after April 2016

Guaranteed Minimum Pensions are no longer offset against a person's state pension



Note

1 The figure is illustrative and intended to show how Guaranteed Minimum Pensions will be factored into pension payments after April 2016. The value of each person's entitlement will vary depending on their employment history.

Source: National Audit Office

The government's uprating will no longer help to maintain the value of Guaranteed Minimum Pensions

2.18 The government will uprate state pension payments each year "at least in line with the growth in average earnings".[14] The annual increase will be set by Parliament.

2.19 The obligation on pension scheme providers to uprate occupational pension payments has not changed. Scheme providers will uprate occupational pensions, net of Guaranteed Minimum Pensions, according to scheme rules and statutory requirements.[15] After April 2016 HMRC and the Department will not monitor this.

2.20 As with existing pension rules, scheme providers will continue to uprate Guaranteed Minimum Pensions as follows:

- the value of Guaranteed Minimum Pensions earned in respect of service between 1978 and 1988 will not be uprated; and
- the pension scheme provider will uprate Guaranteed Minimum Pensions earned between 1988 and 1997, up to a maximum of 3%.

2.21 The government will no longer take account of the value of Guaranteed Minimum Pensions when it uprates the new state pension each year. In effect, this means that Guaranteed Minimum Pensions will not be uprated fully via the state pension (**Figure 6** overleaf). However, individual schemes may decide to uprate Guaranteed Minimum Pensions for those affected by this change. For example, in March 2016 the government, as an employer, announced that it will continue to price protect the Guaranteed Minimum Pensions of members of public sector contracted-out pension schemes who reach state pension age before 6 December 2018.[16]

2.22 The introduction of the new state pension will lead to a number of changes for people with Guaranteed Minimum Pensions. The main changes are summarised in **Figure 7** on page 23.

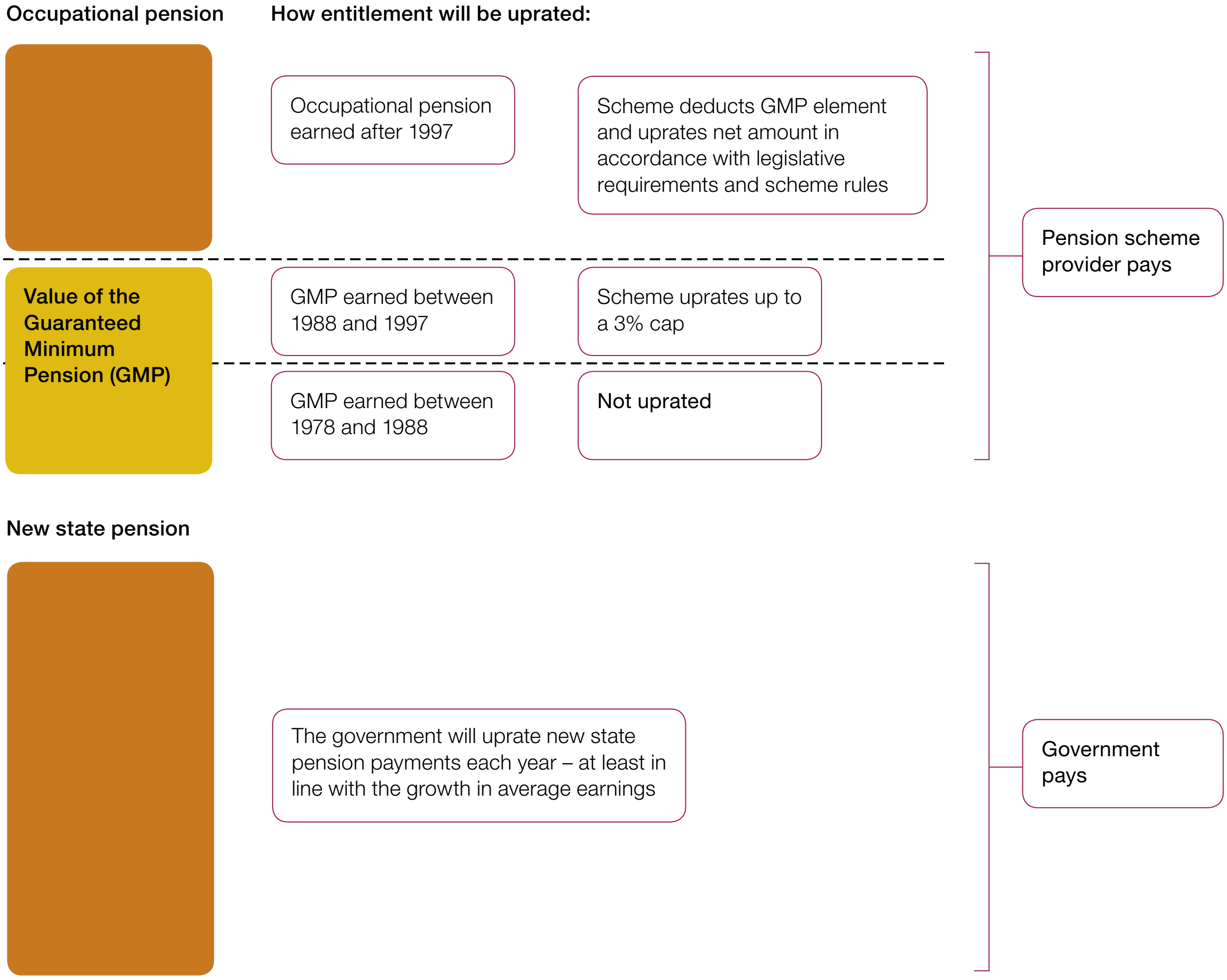
14 Department for Work & Pensions, *The single-tier pension: a simple foundation for saving*, Cm 8528, January 2013, paragraph 99.

15 The statutory requirement will remain that scheme providers uprate post-1997 accruals at CPI, capped at 5% for accruals between 6 April 1997 and 5 April 2005, and CPI capped at 2.5% for accruals since 6 April 2005.

16 The government's rationale for this decision is to ensure that the Guaranteed Minimum Pensions part of public sector pension payments will be treated in the same way for men and women born on the same date. Available at: www.gov.uk/government/news/government-one-step-closer-to-introducing-new-state-pension-this-year

Figure 6
How pensions will be uprated

From 6 April 2016 Guaranteed Minimum Pensions will only be uprated by scheme providers



Source: National Audit Office

Figure 7
Overview of changes to pension arrangements

The new state pension will lead to a number of changes for people with Guaranteed Minimum Pensions

Build-up of entitlement	State pension rules – to 5 April 2016	New state pension rules – from 6 April 2016
If the person leaves the occupational scheme before scheme pension age	Scheme provider is responsible for revaluing the Guaranteed Minimum Pension	No change
At Guaranteed Minimum Pension age (60 for women, 65 for men)	Scheme provider calculates entitlement, agreeing Guaranteed Minimum Pension with HM Revenue & Customs	**Scheme provider calculates entitlement, agreeing the Guaranteed Minimum Pension with HM Revenue & Customs using an online self-service**
Calculation		
Payment of occupational pension before state pension age	Scheme providers uprate pension payment in accordance with scheme rules and statutory requirements Not all of the Guaranteed Minimum Pension is uprated once a person reaches Guaranteed Minimum Pension age. The government does not provide any additional indexation	No change to rules – although the **increasing gap** between Guaranteed Minimum Pension age and state pension age means that there could be a **longer period without full uprating**
Calculation at state pension age	The Department calculates state pension, including a deduction to reflect the value of the Guaranteed Minimum Pension	The Department will calculate new state pension – based on the starting amount plus additional qualifying years
Uprating		
Uprating pension payments	Uprating Guaranteed Minimum Pensions is split between scheme providers and government: The government uprates state pension: • basic state pension uprated using triple lock; and • additional state pension uprated using CPI	**The government will no longer increase the state pension to maintain the value of Guaranteed Minimum Pensions** **The government will uprate the new state pension at least in line with earnings growth and 'protected payments' using CPI**
	Pension scheme providers uprate payments – net of the Guaranteed Minimum Pension – according to scheme rules and statutory requirements	No change

Source: National Audit Office

Part Three

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

3.1 This part considers the implications of the new state pension reforms for people with Guaranteed Minimum Pensions.

State pension reforms affect Guaranteed Minimum Pensions in several ways

3.2 The Department for Work & Pensions (the Department) estimates that 2 million people will reach state pension age in the five years after the new state pension is introduced. Of these, around 40% to 45% will have contracted out of private and public sector defined benefit schemes between 1978 and 1988, and will have Guaranteed Minimum Pensions.

3.3 The pension reforms will impact on:

i) the period of time between individuals reaching Guaranteed Minimum Pension age and state pension age;

ii) responsibilities for calculating Guaranteed Minimum Pensions; and

iii) uprating of Guaranteed Minimum Pensions after state pension age.

i) The value of Guaranteed Minimum Pensions will be affected by the rising state pension age

3.4 As the state pension age is rising, for women since 2010, and for both men and women from December 2018, the gap between Guaranteed Minimum Pension age (60 for women and 65 for men) and the state pension age will increase. The changes to state pension age will not change the respective responsibilities of government or pension scheme providers in respect of Guaranteed Minimum Pensions. But there could be a longer period of time in which a person's Guaranteed Minimum Pension is not uprated fully before the state pension is payable.

3.5 For example, a woman born in the early 1960s, who will now reach state pension age when she is 67, could have been paying into a contracted-out pension scheme since the late 1970s. This person would have a seven-year difference between her Guaranteed Minimum Pension age and state pension age. During that seven-year period, the Guaranteed Minimum Pension will not be uprated fully and the person will not be drawing their state pension.

3.6 **Figure 8** illustrates the impact of this gap on the value of Guaranteed Minimum Pensions. For example, with inflation at 1.7% and a one-year gap between Guaranteed Minimum Pension age and state pension age, the annual occupational pension payment would be £17 lower in 2015-16 prices by the time the person reaches state pension age. At the other end of the scale, with inflation of 5% and a seven-year gap, the person's annual occupational pension payment would £415 lower in 2015-16 prices, which is about £8 per week.

Figure 8

Impact of increasing state pension age on uprating Guaranteed Minimum Pensions

The value of Guaranteed Minimum Pensions will be eroded as the state pension age increases

This illustration is based on a person with a Guaranteed Minimum Pension of £2,000, split:

- £1,000 arising from earnings between 6 April 1978 and 5 April 1988; and
- £1,000 arising from earnings between 6 April 1988 and 5 April 1997.

Number of years difference between Guaranteed Minimum Pension age and state pension age	Annual loss in 2015-16 prices if Guaranteed Minimum Pension is not uprated by CPI		
	CPI at 1.7% (£)	CPI at 3% (£)	CPI at 5% (£)
1 year	17	29	67
2 years	33	57	131
3 years	49	85	193
4 years	65	112	252
5 years	81	137	308
6 years	96	162	363
7 years	111	187	415

Source: National Audit Office

ii) Scheme providers will be responsible for calculating the value of Guaranteed Minimum Pensions

3.7 After 6 April 2016 pension scheme providers alone will be responsible for calculating and uprating Guaranteed Minimum Pensions. Individuals will be notified of the value of their Guaranteed Minimum Pension as at April 2016 and then expected to keep a record, including where they make a transfer to another pension scheme. HM Revenue & Customs (HMRC) will not monitor the system for calculating Guaranteed Minimum Pensions after April 2016. By April 2018 HMRC will write to everyone who has been contracted-out providing them with details of who holds their Guaranteed Minimum Pension.

iii) Uprating Guaranteed Minimum Pensions after state pension age will be partial

3.8 Each person's pension entitlement depends on their employment history and the type of pension scheme they have been in. We assessed the implications of state pension reforms by modelling a range of scenarios. This showed that the impact on people with Guaranteed Minimum Pensions depends on the time that the person has already spent in contracted-out schemes and how close they are to retirement – which affects the time they have to build up additional entitlement under new rules.

3.9 We have illustrated the potential impacts using three scenarios:

- a person who has been in a contracted-out scheme for much of their working life and reaches state pension age soon after 6 April 2016;
- a person in a contracted-out scheme who has a later retirement date and so has built higher starting amount of new state pension; and
- someone who does not retire for another 9 to 10 years and can build their entitlement to the full rate of new state pension.

In each case, we assessed how the pension would be uprated, comparing the new rules for uprating Guaranteed Minimum Pensions with the existing rules. We used the same assumptions as the example in Figure 3 on page 15 to provide a baseline to assess the impact of the reforms. We use a 5% inflation rate, which is higher than the Office for Budget Responsibility's current inflation forecast, in order to illustrate how the new state pension rules could affect people with Guaranteed Minimum Pensions.

3.10 Figure 9 illustrates how a person might be affected if they reached state pension age soon after April 2016 and, as they had been in a contracted-out scheme, has not qualified for any additional state pension before April 2016. As the government is no longer responsible, in effect, for uprating part of the Guaranteed Minimum Pension, the individual will not get the £70 increase to the additional state pension that they would previously have received (see Figure 3). Further, as the starting amount of new state pension is the same as the old system, the government's uprating of state pension entitlement will not offset any of these losses. Our modelling indicates that, in these circumstances, the person could receive around £8,200 (about £8 per week) less pension in 2015-16 prices over a 20-year period, compared with the current system. If the model uses the Office for Budget Responsibility's inflation forecast instead of 5%, a person could receive around £3,100 (about £3 per week) less pension in 2015-16 prices over a 20-year period, compared with the current system.

Figure 9
Example of new pension arrangements with low starting amount

From April 2016, the government will only uprate the new state pension

The person:

- reaches state pension age soon after 6 April 2016, so the new pension rules apply;
- has a starting amount equivalent to the maximum basic state pension;
- paid the contracted-out rate of National Insurance from the late-1970s to mid-1990s, so has built up a Guaranteed Minimum Pension which relates to earnings both before and after 6 April 1988; and
- has an occupational pension that exceeds the Guaranteed Minimum Pension, the balance of which is uprated at the notional 5% CPI rate used in this example.

Pension element	Initial pension amount	Increase paid by the pension scheme		Increase paid by the government		Total annual cash increase in first year	
	(£)	(%)	(£)	(%)	(£)	(%)	(£)
New state pension	**6,029**	–	–	5.0	301	**5.0**	**301**
Occupational pension	**6,000**	3.8	230	–	–	**3.8**	**230**
Pre-1988 GMP	1,000	–	–	–	–	–	–
Post-1988 GMP	1,000	3.0	30	–	–	3.0	30
Occupational pension excluding GMP	4,000	5.0	200	–	–	5.0	200
Total	**12,029**	1.9	230	2.5	301	**4.4**	**531**

Note

1 The 5% inflation rate is used for illustrative purposes, in order to demonstrate how the new state pension rules work.

Source: National Audit Office

3.11 Figure 10 illustrates how someone with a higher starting amount of new state pension might be affected; for example, a person who has added qualifying years to their starting amount. As with the previous example, the person loses £70 as the government does not pay for any uprating of the Guaranteed Minimum Pension. This is offset in part by the higher starting rate of new state pension, and the annual increase paid by the government in the first year would be £337. This is higher than the previous example (Figure 9), although still less than the increase the person would have received under the current system (Figure 3). However, the higher starting amount means that total pension payments will be higher than the current system. In these circumstances, the person could receive about £1,400 (about £1 per week) more pension in 2015-16 prices over a 20-year period.

3.12 Figure 11 illustrates how someone who is eligible for the maximum new state pension might be affected. As the person is eligible for the maximum rate, the annual increase paid by the government in the first year would be £393. This is higher than the increase the government would have paid under the current system (Figure 3). Both the starting pension payment, and the total pension after the first year, are higher than the person would have received under the current system. In these circumstances, the person could receive around £16,500 (about £16 per week) more pension in 2015-16 prices over a 20-year period, compared with the current system.

Figure 10
Example of new pension arrangements with higher starting amount

Uprating a higher new state pension helps to offset the government no longer uprating Guaranteed Minimum Pensions

The person:

- reaches state pension age soon after 6 April 2016, so the new pension rules apply;
- has added some qualifying years to their starting amount, so the new state pension entitlement is higher than the basic state pension would have been;
- paid the contracted-out rate of National Insurance from the late-1970s to mid-1990s, so has built up a Guaranteed Minimum Pension that relates to earnings both before and after 6 April 1988;
- has an occupational pension that exceeds the Guaranteed Minimum Pension, the balance of which is uprated at the notional 5% CPI rate used in this example.

Pension element	Initial pension amount	Increase paid by the pension scheme		Increase paid by the government		Total annual cash increase in first year	
	(£)	(%)	(£)	(%)	(£)	(%)	(£)
New state pension	**6,741**	–	–	5.0	337	**5.0**	**337**
Occupational pension	**6,000**	3.8	230	–	–	**3.8**	**230**
Pre-1988 GMP	1,000	–	–	–	–	–	–
Post-1988 GMP	1,000	3.0	30	–	–	3.0	30
Occupational pension excluding GMP	4,000	5.0	200	–	–	5.0	200
Total	**12,741**	1.8	230	2.6	337	**4.5**	**567**

Note

1 The 5% inflation rate is used for illustrative purposes, in order to demonstrate how the new state pension rules work.

Source: National Audit Office

Figure 11

Example of new pension arrangements with maximum new state pension

Uprating the maximum new state pension offsets Guaranteed Minimum Pensions not being uprated by the government

The person:

- reaches state pension age after 6 April 2016, so the new pension rules apply;
- has added enough qualifying years to the starting amount to qualify for maximum new state pension when they reach state pension age;
- has paid the contracted-out rate of National Insurance from the late-1970s to mid-1990s, so has built up a Guaranteed Minimum Pension that relates to earnings before and after 6 April 1988; and
- has an occupational pension that exceeds the Guaranteed Minimum Pension, the balance of which is uprated at the notional 5% CPI rate used in this example.

Pension element	Initial pension amount	Increase paid by the pension scheme		Increase paid by the government		Total annual cash increase in first year	
	(£)	(%)	(£)	(%)	(£)	(%)	(£)
New state pension	**7,865**	–	–	5.0	393	**5.0**	**393**
Occupational pension	**6,000**	3.8	230	–	–	**3.8**	**230**
Pre-1988 GMP	1,000	–	–	–	–	–	–
Post-1988 GMP	1,000	3.0	30	–	–	3.0	30
Occupational pension excluding GMP	4,000	5.0	200	–	–	5.0	200
Total	**13,865**	1.7	230	2.8	393	**4.5**	**623**

Note

1 The 5% inflation rate is used for illustrative purposes, in order to demonstrate how the new state pension rules work.

Source: National Audit Office

3.13 Our analysis shows that the type of person who will do comparatively worse under the new state pension is someone who is close to retirement on 6 April 2016 and has been in a contracted-out pension scheme for much of their working life. This is because:

- their starting amount of new state pension is the same or little more than they get under current arrangements;
- they have a higher proportion of their Guaranteed Minimum Pension coming from pre-1988 employment; and
- they have little, or no, time to build their new state pension entitlement by adding qualifying years.

In our modelling, someone whose new state pension is the same value as it would have been under the current state pension, and who has some Guaranteed Minimum Pensions earned between 1978 and 1988, does comparatively worse in all the scenarios that we tested (see Appendix One). For example, using the Office for Budget Responsibility's inflation forecast, our model indicates that a person with a Guaranteed Minimum Pension of £2,000 accrued before 1988 would be £6,300 worse off over a 20-year period (in 2015-16 prices), an average of £6 per week.

3.14 The Department estimates that between 164,000 and 185,000 people who reach state pension age in 2016-17 will have Guaranteed Minimum Pensions from before 1988. 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.

3.15 Our analysis shows that the type of person who will do comparatively better under the new state pension is someone who is further away from retirement and thus has the opportunity to earn additional qualifying years after 6 April 2016; or has a starting amount that is based on a higher level of additional state pension derived from periods of employment when they were not contracted out. This is because:

- their starting amount of new state pension is higher than they could get under current arrangements; and
- they have low or no pre-1988 Guaranteed Minimum Pension.

In our modelling, someone who has earned one additional qualifying year of pension entitlement under the new state pension would do as well or comparatively better than before, provided inflation remains below 1.7%. Were inflation to rise to 5%, the person would need an additional four qualifying years under the new state pension to at least break even in all of the scenarios we modelled.

3.16 The actual impact on individuals will depend on their particular circumstances, government policy for uprating the state pension and future inflation rates. Our modelling shows that different scenarios can lead to wide variations in pension payments over a 20-year period (Appendix One). Our model assesses the impact of pension reforms on the pension payments of a person whose total Guaranteed Minimum Pension is £2,000. This shows that, compared with current arrangements, the person could receive between £35,600 more in 2015-16 prices (on average £34 a week more) and £11,100 less (on average £11 a week less), depending on how they built up their pension entitlement and future inflation rates.

3.17 In general, our modelling shows that under the new state pension:

- people will do better if most of their Guaranteed Minimum Pension is post-1988. This is because the government requires scheme providers to uprate these Guaranteed Minimum Pensions up to a 3% maximum;
- people do comparatively better when their starting new state pension is higher than they would have got under the current system. This is because the increase from the annual uprating of the new state pension will be greater than the amount notionally lost because of the government no longer paying for part of the uprating of Guaranteed Minimum Pensions; and
- people will do comparatively worse if inflation is above 3%. This is because pre-1988 Guaranteed Minimum Pensions would not be uprated at all, and scheme providers would only uprate post-1988 Guaranteed Minimum Pensions up to the 3% cap.

Part Four

The Department's assessment and communication of the impact of state pension reforms on Guaranteed Minimum Pensions

4.1 This part considers the assessment of the impact of pension reforms by the Department for Work & Pensions (the Department), and how it has communicated the impacts to people who will be affected.

The Department's assessment of new state pension reforms on Guaranteed Minimum Pensions

4.2 In November 2014 the Department considered the aggregate impact of introducing the new state pension. It used case studies to illustrate how individuals could be affected by the reforms, including the end of contracting out, which showed:

- older individuals are more likely to have been in defined benefit schemes and are therefore more likely to be affected by the end of contracting out;
- younger people (particularly higher earners) will be less able to build up entitlement to large sums of additional state pension (although this will be protected for older people who have already made National Insurance contributions);
- the majority of people reaching state pension age between 2016 and 2040 will have a higher net income over their retirement; and
- some pensioners may receive less state pension than they would have done under current arrangements because of the introduction of the 10-year minimum qualifying period.

4.3 The Department has identified the type of person who may gain or lose out as a result of pension reforms. In January 2016 it published new analysis on the impact of the new state pension on an individual's pension entitlement.[17] The Department modelled the long-term implications for people who had been contracted out up to 1988, based on a simulation of 60,000 hypothetical individuals. The modelling forecasts that up to 2020, between 41% and 44% of people reaching state pension age after 6 April 2016 will have been contracted-out at some point before 1988. DWP estimates that in 2020, 25% of these people will be notionally worse off by, on average, £2 per week, because of the aggregate impact of the new State Pension. In contrast, it estimates that 75% will be, on average, £4 per week better off.

17 Department for Work & Pensions, *Impact of New State Pension (nSP) on an Individual's Pension Entitlement – Longer Term Effects of nSP*, January 2016.

4.4 The Department has not, though, used information on peoples' actual circumstances to establish how individuals with Guaranteed Minimum Pensions might be affected. It does have information of individuals' pensions on its Pension Service Computer System, including a breakdown of Guaranteed Minimum Pensions, but it is not able to easily extract these data. While the Department has modelled the aggregate impact of pension reforms, it has not analysed how individuals in contracted-out schemes will gain or lose out as a result of these reforms, and by how much.

4.5 The existing state pension rules mean that the government has been paying a share of the annual uprating of Guaranteed Minimum Pensions. As explained in Part One, it has recalculated its share annually and paid this as part of the additional state pension. However, the Department does not disentangle the overall additional state pension payment to monitor how much has been earned through National Insurance contributions, and how much from uprating the state pension after a person has started drawing it. The Department therefore does not know what element of additional state pension payments reflect its share of the uprating of Guaranteed Minimum Pensions. It has previously had no reason to calculate this.

The Department's communications on the impact of changes

4.6 Several members of the public have contacted us regarding the implications for Guaranteed Minimum Pensions of introducing the new state pension. In particular, correspondents have raised concerns about the way Guaranteed Minimum Pensions will be uprated, and the quality of communications from the Department about how people will be affected.

4.7 Communicating the impact of pension reforms is not straightforward. Pension rules are complicated and it is not easy to generalise about the impact of policy changes on individuals, given the number of factors that can affect their entitlement.

4.8 In March 2015 we wrote to the Department to highlight a lack of publicly available information and guidance on the scenarios under which pensioners might receive less pension under the new state pension. We found that it had not communicated the scenarios in which people could be worse off. We recommended that the Department review its communication strategy and distribute clear guidance, including scenarios relating to the end of contracting out and the indexation of Guaranteed Minimum Pensions' increases.

4.9 The Minister of State for Pensions has made numerous statements on the pension reforms and the end of contracting out, including the impact on Guaranteed Minimum Pensions. The Department has also published information on new state pension reforms. In July 2015 it issued a factsheet *The new State Pension transition and contracting out*, which highlighted the changes in calculating pension entitlement following periods of contracted-out employment. This also explains how the reforms will affect the uprating of Guaranteed Minimum Pensions under the new system. The Department has acknowledged that some people may lose out under the new system, but has not provided details on the circumstances in which individuals could end up worse off. The Department said that it is not straightforward to calculate an accurate and meaningful estimate of the effect of any one aspect of state pension reform on individuals, because of the number of variable circumstances it would need to take into account.

4.10 Since August 2015 the Department has increased the level of communication of new state pension reforms. The campaign, which is targeted at those aged 50 plus, includes:

- offering people personal statements so they can find out how they are affected – up to October 2015 it had issued nearly 500,000 individual new state pension statements;[18]
- providing a state pension toolkit on GOV.UK, with factsheets and guides on forthcoming changes;
- from February 2016, enabling anyone who has verified their identity on the GOV.UK website to view their pension forecast; and
- using other channels, such as YouTube and a weekly bulletin.

The Department is also planning to issue a new factsheet on the effect of pension reforms on Guaranteed Minimum Pensions.

4.11 The Department has revised the format of pension statements and provided more information about contracting out to give people an indication of the state pension that they have foregone. It is continuing to revise the content and presentation of personal pension statements.

18 Until 29 February 2016 this service was restricted to people aged 55 or more; the minimum age has now been reduced to 50.

Appendix One

Modelling of the impact of state pension reforms on people with Guaranteed Minimum Pensions

1 We modelled a range of scenarios, based on a pension that has been in payment for 20 years, to illustrate the impact different circumstances might have (**Figure 12**). The variables we used were:

- total Guaranteed Minimum Pension of £2,000 is split between pre-1988 and post-1988 according to different ratios, ranging from all the Guaranteed Minimum Pension being attributed to pre-1988 earnings to all being attributed to post-1988 earnings;
- each scenario then uses the same three permutations:
  - comparing people who have maximum qualifying years under both the current system (30 years) and the new system (35 years);
  - comparing people who have the same qualifying years (30 years) under both the current system and the new system; and
  - comparing people who have the same state pension (£6,029 – the maximum annual basic state pension in 2015-16) under both the current system and the new system; and
- finally, each permutation is analysed by three inflationary situations:
  - low inflation: triple lock at 2.5%, CPI at 1.7%;
  - medium inflation: both triple lock and CPI at 3%; and
  - higher inflation: both triple lock and CPI at 5%.

2 It is assumed throughout that: basic state pension and new state pension are uprated using the triple lock; Guaranteed Minimum Pensions and additional state pension by CPI; CPI is equal to or exceeds earnings growth throughout the 20-year period; and the inflationary situation remains at the same rate for all 20 years.

3 Calculations for the current pension system are based on the annual maximum basic state pension in 2015-16 of £6,029.40 (£115.95 per week). Calculations for the new single-tier state pension are based on the illustrative figure used by the Department for 2015-16 – £7,865 per annum (£151.25 per week).

4 All figures are rounded to the nearest £100, and are in 2015-16 prices.

Figure 12

Illustration of the possible impact of pension reforms on total retirement income over 20 years compared with current system

Initial state pension	Uprating factors	Cumulative gain/(loss) in 2015-16 prices over 20 years under new single-tier state pension compared to current system (£)				
		Scenario 1	**Scenario 2**	**Scenario 3**	**Scenario 4**	**Scenario 5**
		Pre-1988 GMP: £NIL	**Pre-1988 GMP: £500**	**Pre-1988 GMP: £1,000**	**Pre-1988 GMP: £1,500**	**Pre-1988 GMP: £2,000**
		Post-1988 GMP: £2,000	**Post-1988 GMP: £1,500**	**Post-1988 GMP: £1,000**	**Post-1988 GMP: £500**	**Post-1988 GMP: £NIL**
Maximum qualifying years for current basic state pension (30 years) or new single-tier pension (35 years)	Triple lock: 2.5% CPI: 1.7%	35,600	34,200	32,800	31,300	29,900
	Triple lock: 3.0% CPI: 3.0%	29,100	27,000	24,900	22,800	20,600
	Triple lock: 5.0% CPI: 5.0%	19,400	18,000	16,500	15,100	13,600
30 qualifying years for current basic state pension or new single-tier pension	Triple lock: 2.5% CPI: 1.7%	13,800	12,400	11,000	9,500	8,100
	Triple lock: 3.0% CPI: 3.0%	11,300	9,200	7,100	4,900	2,800
	Triple lock: 5.0% CPI: 5.0%	4,300	2,800	1,400	(100)	(1,500)
Initial current basic state pension or new single-tier pension is £6,029	Triple lock: 2.5% CPI: 1.7%	0	(1,400)	(2,900)	(4,300)	(5,700)
	Triple lock: 3.0% CPI: 3.0%	0	(2,100)	(4,300)	(6,400)	(8,500)
	Triple lock: 5.0% CPI: 5.0%	(5,300)	(6,800)	(8,200)	(9,700)	(11,100)

Source: National Audit Office

Appendix Two

Glossary

1 **Additional state pension:** an earnings-related payment made on top of the basic state pension to people who have sufficient earnings on which National Insurance contributions were paid (or treated as paid) and were not in a contracted-out scheme. Variants of the additional state pension are the State Earnings-Related Pension Scheme (SERPS) between 1978 and 2002, and the State Second Pension from 2002. The additional state pension will not continue for people who reach state pension age from 6 April 2016, who will instead receive the new state pension.

2 **Basic state pension:** a regular payment from government to a person when they reach state pension age, based on qualifying years of National Insurance contributions or credits. The basic state pension will not continue for people reaching state pension age from 6 April 2016, who instead will receive the new state pension.

3 **Consumer Price Index (CPI):** a measure of changes in the price level of consumer goods and services purchased by households. It is published by the Office of National Statistics and has been used to uprate most state benefits from April 2011.

4 **Contracting out:** a statutory arrangement under which a person builds a private pension which has contracted out of the additional state pension. On retirement, the person receives a pension from the scheme instead of additional state pension. If the scheme is a **defined benefit** pension, the employer and employee pay a lower rate of National Insurance contributions. Between 1988 and 2012, people could also contract out through paying into a **defined contribution** pension scheme, whereby some of their National Insurance contributions were paid into a private pension fund. With the introduction of the new state pension on 6 April 2016, all contracting out will end.

5 **Guaranteed Minimum Pensions:** the minimum pension that a contracted-out defined benefit pension scheme must pay to people who were members between 6 April 1978 and 5 April 1997.

6 **New state pension:** a pension that replaces the current state pension system for people who reach state pension age from 6 April 2016. Qualifying years from then onwards add pension at a single-tier rate. The amount a person receives will depend on the number of qualifying years they have earned. For people who have paid National Insurance contributions before 6 April 2016, their new state pension entitlement will include their **starting amount**.

7 **Qualifying year:** a complete tax year during a person's working life in which they have sufficient credits or earnings on which National Insurance contributions have been paid (or treated as paid) to earn the right to receive a proportion of the state pension when they retire.

8 **Starting amount:** will be calculated by applying new state pension rules and current state pension rules to a person's pre-2016 National Insurance contributions record, and will be the higher of the two calculations.

9 **State pension age:** the earliest age at which a person can claim their state pension, as laid down by legislation.

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