

Background

The new State Second Pension (S2P) replaced SERPS from 6th April 2002 and is designed specifically to assist lower earners. This is particularly significant given that the basic state pension is now increased in line with prices (retail prices index), rather than earnings (national average earnings).

The question of whether or not to contract out of the state pension scheme (currently State Second Pension – S2P – previously State Earnings Related Pension Scheme – SERPS) is a difficult and complex one and, to a large extent, there is neither a right nor a wrong answer.

The State Earnings Related Pension Scheme (SERPS) commenced in 1978 as an additional benefit on top of the basic state pension, dependent upon national insurance contributions paid throughout working life. The maximum benefits were originally 25% of middle band earnings, revalued by national average earnings, but for individuals who reached state pension age later than the 1999/2000 tax year, this was reduced to 25% of the best 20 years' revalued middle band earnings. From 1988 the formula was cut back to a maximum 20% of average revalued middle band earnings over an entire working life.

Entitlement to S2P benefits is calculated by reference to three different bands of earnings:-

1. between the Lower Earnings Limit (set at £4,524 for 2007/08 and increasing by RPI) and the Lower Earnings Threshold (set at £13,000 for 2007/08 and increasing by NAE), benefits will build up at twice the SERPS rate, i.e. 40% for those reaching State Pension Age (SPA) after 5th April 2009.
2. between the Lower Earnings Threshold (see above) and the Upper Earnings Threshold (set at £30,000 for 2007/08) - benefits will build up at half the SERPS rate, i.e. 10% for those reaching State Pension Age (SPA) after 5th April 2009.
3. between the Upper Earnings Threshold (see above) and the Upper Earnings Limit (set at £34,840 for 2007/08) - benefits will build up at the same rate as SERPS, i.e. 20% for those reaching State Pension Age (SPA) after 5th April 2009.

Similarly to SERPS, there will be a sliding scale for those whose State Pension Age (SPA) falls before 2009/2010.

Individuals who earn between the Lower Earnings Limit and the Lower Earnings Threshold will be treated as if they earn the Lower Earnings Threshold (even if they do not earn enough to pay National Insurance contributions!).

Some individuals who earn less than the Lower Earnings Limit (otherwise known as the Qualifying Earnings Factor), who fall into specific defined categories (e.g. some carers and those in receipt of certain state benefits) will be treated as if they earn the Lower Earnings Threshold figure and will build up S2P benefits accordingly. All other individuals, earning less than the Lower Earnings Limit will not, however, have any entitlement to S2P.



It is predicted that S2P benefits will change to a flat-rate scheme and will only apply to low earners.

At present, S2P will not be available to the self-employed.

As with SERPS, it is possible to contract out of the S2P and make private provision by means of an Appropriate Personal Pension, whereby part of an individual's National Insurance Contributions will be rebated into a personal/stakeholder pension, along with an age-related rebate.

Individuals who contract out will forego their rights to SERPS/S2P for the years in question but will retain those rights for the years they were contracted into SERPS/S2P. The decision whether to remain contracted in or to contract out of the state scheme can be made on an annual basis.

The National Insurance rebates are invested in a fund to provide 'Protected Rights'. These 'Protected Rights' can be taken from the age of 50 rising to age 55 by 2010.

The decision whether or not to contract out of S2P is not straightforward and will depend on each individual Customer's family circumstances, age, sex and attitude to investment risk. There are no sweeping categories which make the decision obvious. There are advantages and disadvantages to contracting in and contracting out and some of the issues you should bear in mind are included below:-

Remaining Contracted Into S2P (i.e. not contracting out of S2P)

Advantages

- a. a guaranteed state pension, which will increase in payment by RPI
- b. the higher the earnings, the more S2P will be built up (at present)
- c. state pensions are not included in the 'lifetime allowance'
- d. no risk of investments performing poorly and this having an impact on benefits
- e. it is possible to obtain figures via a BR19 form which will give a fair indication of what state benefits will be provided (though things could change)

Disadvantages

- a. the accrual rates could change in the future
- b. a flat-rate accrual in the future could mean that higher earners lose out
- c. there is no opportunity to improve on the level of state benefits
- d. benefits cannot be taken before State Pension Age (SPA)
- e. death benefits are being reduced in respect of individuals who die after 6th October 2002 with a State Pension Age that would have been after 6th October 2010: widow(er)s' benefits are reducing from 100% to 50%.
- f. No death benefits available for individuals who are single at date of death

Contracting Out of S2P

Advantages

- a. opportunity to improve on the level of benefits provided by the state
- b. protected rights benefits can be taken from the age of 50 rising to age 55 by 2010.
- c. rebates are paid as an incentive, depending on an individual's age – they are unisex and calculated using female mortality and state pension ages – this is advantageous to males who benefit from earlier assumed pension ages (i.e. female SPA under 65)
- d. when S2P is paid as a flat-rate, those earning above the Lower Earnings Threshold will lose out
- e. if the 'real' interest rate used in calculating annuity rates is low, a lower investment fund will be required to improve on the state benefit given up
- f. for individuals who die prior to retirement with no qualifying widow(er) or dependant the benefit can be paid as a lump sum (allowing single people to pass on their pension to their heirs)
- g. benefits can be calculated on a single life basis
- h. up to 25% of the contracted out personal pension fund can be taken as tax-free cash (no tax-free cash is available from SERPS/S2P)

Disadvantages

- a. the level of annuity (income) is completely unknown and non-guaranteed
- b. the fund may produce a lower annuity than that offered by the state
- c. levels of interest and mortality rates (and consequently annuities) at retirement will be unknown
- d. if the 'real' interest rate used in calculating annuity rates is high, a higher investment fund will be required to improve on the state benefit given up
- e. compulsory provision for spouse' pension unless member is single when benefits are drawn
- f. current poor age-related rebate levels

Contracting Out Summary

Essentially, the financial considerations are marginal and Product Providers are, in the main, no longer providing 'pivotal age' tables as they used to, which laid down ages for contracted-out males and females, at which it was advantageous financially to contract back into the state scheme.

One or two Providers have 'pivotal yield gap' tables, which give an indication of the amount by which a contracted-out fund will have to beat the rate of inflation in order to make contracting out worthwhile.

Some Providers have categorically stated that the current level of contracted-out rebates would suggest that nobody should contract out and anybody currently contracted-out should immediately contract back in.

Some pensions consultants have suggested that, with S2P being effectively salary-linked, it provides investment diversification for those with other, money purchase pension arrangements.

So much depends on factors which are unknown – for example, for a contracted-out individual, if inflation is high at the time of an individual's retirement, then compulsory LPI will mean they need an increased fund to provide a similar pension at commencement to that available at a time of low inflation. Past performance is no guarantee of future returns and equity markets can be volatile; unit prices can go down as well as up. Therefore, the choice of contracted-out investment fund is crucial.

On the other hand, state benefits are reducing and, when the flat rate S2P is introduced, higher earners may be better off by contracting out.

According to research by the the UK financial services regulator - the FSA – most of the 8 million or so people in the UK who have contracted out are likely to be financially worse off than if they had remained in SERPS/S2P. The main reason for this has been the cut in the level of 'rebate' paid by the Government into contracted out personal pension plans.

The FSA's research suggests that the current amount of 'rebate' paid into contracted out personal pension plans may need to rise by around 40% to 50% to make contracting out worthwhile.

Ultimately, the decision whether or not to contract out comes down, in the main, to an individual's attitude to risk.

Do you want to rely on the government to provide you with state benefits (whatever level and form these might actually take? After all, the government has introduced the Minimum Income Guarantee and its replacement (from 6th October 2003) the Pension Credit.

Alternatively, do you they prefer to take a risk and make alternative provision for yourself and remain contracted out of S2P?

At the end of the day, state pensions alone – or the alternative protected rights (appropriate personal pension) benefits – will rarely meet an individual's total income needs in retirement.

We encourage all of our clients to make additional pension provision by means of an employer-sponsored pension or personal pension arrangement (or perhaps a combination of both).

It is very hard for us to give individual advice regarding Contracting Out of S2P as there would appear to be no right or wrong answer. We do not have access to a crystal ball. Many of the Government promises made about SERPS back in 1978 were subsequently eroded by future legislation.

If you deem yourself to be a risk adverse person you may want to contract back in to S2P in the current tax year. (Please read the advantages and disadvantages of contracting back in given above).

If you wish to contract back in to S2P please complete the enclosed National Insurance form APP2 and return this to us in the pre-paid envelope provided.

If you are comfortable with the advantages and disadvantages of remaining contracted out of S2P you may wish to remain contracted out and need take no action.