# Guaranteed Minimum Pensions – annual increases

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Since the additional State Pension was introduced in 1978, it has been possible to contract-out of it into a pension scheme that meets certain criteria. Where an employee is a member of a contracted-out scheme, they and their employer pay a reduced rate of National Insurance (NI), designed to reflect the cost of providing the benefits foregone. Between 1978 and 1997, contracted-out schemes were required to provide a Guaranteed Minimum Pension (GMP). Since 1997, a different test has applied but contracted-out schemes still have to provide a GMP for rights accrued between 1978 and 1997.

Pension schemes are required to index GMP rights accrued between 1988 and 1997, in line with prices, subject to a 3% cap. The increase required by schemes each year is provided for in a draft Statutory Instrument, the *Guaranteed Minimum Pension Increase Order.*

There is a link between the GMP and the additional State Pension in that, when a person reaches pensionable age, the total amount of GMP is subtracted from the total amount of additional state pension built up between 1978 and 1997, and any net amount is paid. This is referred to as a 'contracted-out deduction'. It reflects the fact that reduced National Insurance (NI) was paid during the period of contracting out in return for meeting legislative requirements. This calculation is performed each year that the pension is payable.

The effect of these arrangements is that, although schemes are not required to provide increases on the GMP on rights accrued between 1978 and 1988 (or in excess of 3% on rights accrued between 1988 and 1997), the additional State Pension built up during that period is subject to increases. When the contracted-out deduction is subtracted from the additional state pension, the remaining additional state pension includes an increase linked to prices. In this way, an amount broadly equivalent to the GMP, but which is in fact additional state pension, is subject to an increase (HC Deb, 6 January 2014, c51W).

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## 1 What is a Guaranteed Minimum Pension?

When the State Earnings Related Pension Scheme (SERPS) was introduced in 1978, employers could contract employees out of this provided they were members of an occupational pension scheme which met certain conditions. Contracted-out employers and employees paid lower NICs as they would be receiving a lower state pension. The amount of this reduction – the "contracted-out rebate" – is set by the Government on the advice of the Government Actuary's Department and is designed to reflect the cost of providing the benefits foregone.[1]

Initially, members of contracted-out schemes had to be provided with an individually calculated defined benefit known as the Guaranteed Minimum Pension (GMP). Until April 1988, this was the only contracting out method. The schemes that provided GMPs were usually of the defined benefit type (i.e. provided specified pension benefits, usually based on salary and length of service). However, defined contribution schemes (in which the level of pension depends on contributions made, how these are invested and the annuity purchased) could also contract out by providing a GMP as a defined benefit underpin. The GMP calculation is provided for in section 14 of the *Pensions Schemes Act 1993*

A Department of Health and Social Security (DHSS) leaflet, *New Pensions: a more secure future*, (NP34), issued in January 1978, shortly before the new scheme came into force, explained how it would work:

> The new state pension will operate in partnership with good occupational schemes… if your employer operates such a scheme he can apply to contract you out…of the state scheme's additional pension and you would then pay lower contributions to the state scheme … Your basic pension would then be provided by the state scheme and your additional pension by your employer's occupational scheme, with inflation-proofing after the pension is in payment provided by the state (…)
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> **Guaranteed minimum pensions**
> A contracted-out occupational pension scheme must provide you with at least a guaranteed minimum pension, to match the additional pension you would have earned from the state scheme … Your occupational pension may, of course, be much higher than the guaranteed minimum pension, particularly if you are already a member of a scheme.

[1] Pensions Commission, "Pensions: Challenges and Choices: The First Report of the Pensions Commission", October 2004, Appendix F, p158; This issue is covered in more Library Standard Note SN/BT 2674, State Second Pension: Contracted-out Deductions

The *Pensions Act 1995* abolished the future accrual of GMPs with effect from 6 April 1997, but ensured that rights to GMPs accrued at any time from 6 April 1978 until that date had to be fully protected.[2]

The *Pensions Act 2007* included provision to allow pension schemes to convert GMPs to scheme benefits, from 6 April 2009.[3] The Explanatory Notes said:

> 71. In the White Paper, the Government proposed to introduce a facility for schemes to convert members' rights to a guaranteed minimum pension into rights to an ordinary scheme pension, calculated under the scheme's own rules, subject to certain safeguards to protect the members' interests. Each member's post conversion benefit would be required to be at least as actuarially valuable as their rights immediately prior to conversion.
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> 72. By conducting a guaranteed minimum pensions conversion exercise, a scheme may be able to adopt a unified and streamlined benefit structure which will enable administrative savings to be made as well as offering advantages to members (in terms of understanding their rights in the scheme and being able to transfer them to other schemes more easily). It would be for scheme trustees to decide whether they wished to make use of this facility.[4]

## 2 Contracted-out deductions

The additional state pension and GMPs are linked in that when a person reaches pensionable age, the total amount of GMP is subtracted from the total amount of additional state pension built up between 1978 and 1997, and any net amount is paid. This is referred to as a 'contracted-out deduction'. This subtraction of the total GMP amount is called a 'contracted-out deduction', and reflects that reduced national insurance was paid during the period of contracting out in return for meeting legislative requirements. This calculation is performed each year that the pension is payable.[5] This is provided for in section 46 (1) of the *Pension Schemes Act 1993*, which says:

> **46.**—(1) Where for any period a person is entitled both–
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> (a) to a Category A or Category B retirement pension, a widowed mother's allowance [ , a widowed parent's allowance] [or a widow's pension] under the *Social Security Contributions and Benefits Act 1992*; and
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> (b) to one or more guaranteed minimum pensions, the weekly rate of the benefit mentioned in paragraph (a) shall for that period be reduced by an amount equal–
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>> [(i) to that part of its additional pension which is attributable to earnings factors for any tax years ending before the principal appointed day], or
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>> (ii) to the weekly rate of the pension mentioned in paragraph (b) (or, if there is more than one such pension, their aggregate weekly rates), whichever is the less. […]

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2 IDS Pension Service, *Pension Scheme Design,* May 2010, para 8.43

3 *Pensions Act 2007,* section 14; *Pensions Act 2007 (Commencement No. 3) Order 2009 (SI 2009/406);* Pensions Bill Deb, 1 February 2007, c234

4 *Pensions Act 2007. Explanatory Notes*

5 HC Deb 6 January 2014 c51W

## 3 Indexation arrangements

Defined Benefit occupational schemes are required to increase annually that part of the pension relating to the GMP accrued between 6 April 1988 and 5 April 1997. The increase must be by the lower of the prices or three per cent.[6] The legislation does not specify that a particular measure of prices should be used for GMP uprating, just that it should be in line with the "general level of prices in Great Britain". Until 2011, the Retail Prices Index (RPI) was used. However, in July 2010, the Government announced that it would use the Consumer Prices Indexation (CPI) from April 2011 onwards.[7]

As explained in section 2 above, there is an ongoing link between the GMP and the additional State Pension. A Parliamentary Written Answer from January 2014 explains the effect of these arrangements:

> The Department for Work and Pensions does not pay increases on guaranteed minimum pensions (GMPs). GMPs are occupational pension scheme benefits which were accrued between 1978 and 1997. Pension schemes are liable for any statutory indexation of GMPs, and this liability will not change as a result of the single tier reforms. The Department for Work and Pensions pays state pension benefits and their indexation, including additional state pension (SERPS and S2P) and basic state pension.
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> Additional state pension and GMPs are linked in that when a person reaches pensionable age, the total amount of GMP is subtracted from the total amount of additional state pension built up between 1978 and 1997, and any net amount is paid. This subtraction of the total GMP amount is called a 'contracted-out deduction', and reflects that reduced national insurance was paid during the period of contracting out in return for meeting legislative requirements. This calculation is performed each year that the pension is payable.
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> There is no statutory obligation on schemes to pay increases on GMPs accrued between 1978 and 1988. However, additional state pension built up during that period is subject to increases. When the contracted-out deduction is subtracted from the additional state pension, the remaining additional state pension includes an increase linked to prices. In this way, an amount broadly equivalent to the GMP, but which is in fact additional state pension, is subject to an increase. Schemes are under an obligation to pay increases on GMPs accrued between 1988 and 1997, subject to a cap of 3%.[8]

## 4 GMP increase order

Under section 109 of the *Pension Schemes Act 1993,* the Secretary of State is required to review the general level of prices in Great Britain annually and lay a draft Order before Parliament specifying the percentage by which GMPs are to be increased. This must be in line with the general level of prices, capped at 3%.[9] Each year, the actual percentage increase schemes is provided for in a 'Guaranteed Minimum Pensions Increase Order'. The increase for 2014/15 was provided for by the *Guaranteed Minimum Pensions Increase Order 2014 (SI 2014/515).* The Explanatory Memorandum said:

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6 *Pension Schemes Act 1993,* s109

7 DWP Press release, 12 July 2010

8 HC Deb 6 January 2014 c51W

9 *Pension Schemes Act 1993*, section 109

> 4.1 Under section 109(1) of the *Pension Schemes Act 1993* ("the Act"), the Secretary of State is required to review the general level of prices in Great Britain for the period of 12 months commencing at the end of the period last reviewed. Where that level has increased at the end of the period under review, the Secretary of State is required, under section 109(2) of the Act, to lay a draft Order before Parliament specifying a percentage by which there is to be an increase of the rate of that part of the guaranteed minimum pension which is attributable to earnings factors for the tax years in the relevant period. Under section 109(3A) of the Act, the relevant period is the period beginning with the tax year 1988-89 and ending with the tax year 1996-97. There is no statutory requirement for pension schemes to increase guaranteed minimum pensions accrued between 1978 and 1988.
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> 4.2 In accordance with section 109(3) of the Act, the level of inflation proofing is limited to the increase in the general level of prices or 3 per cent, whichever is less. The Consumer Prices Index for the appropriate review period (i.e. the 12 months commencing on 1 October 2012 and ending on 30 September 2013) was 2.7 per cent. The increase in the guaranteed minimum pension is, therefore, 2.7 per cent.

The GMP Increase Order is generally debated together with the Social Security Benefits Uprating Order.[10] In debate on these Orders on 25 February 2014, Pensions Minister, Steve Webb explained that he expected the Benefits Uprating Order to be the focus of discussions:

> Let me deal first with what is an entirely technical matter that we attend to each year, and not one that I imagine we shall need to dwell on today. The *Guaranteed Minimum Pensions Increase Order 2014* provides for contracted-out defined benefit schemes to increase their members' guaranteed minimum pensions that accrued between 1988 and 1997 by 2.7%, in line with the increase in the consumer prices index to the previous September. I should like to turn now to the *Social Security Benefits Up-rating Order 2014*[…][11]

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[10] See Library Standard Note *SN 5649 State Pension Uprating – 2010 onwards*

[11] HC Deb, 17 February 2011, c1173