Update number 01607 – December 2015

Guaranteed Minimum Pensions & State Pension Reform

(Relevant to those who were contracted out prior to April 1997)

This briefing highlights the detrimental impact of state pension reform on Guaranteed Minimum Pensions (GMPs). This will apply for anyone reaching State Pension age under the new State Pension system being introduced on 6 April 2016. That is men born after 5 April 1951 or women born after 5 April 1953.

What is a GMP?

The state pension system in operation from April 1978 and prior to 6 April 2016 was a two-tiered system. The first tier provided a Basic State Pension and the second tier provided an Additional State Pension, previously called SERPS and more recently re-named as the State Second Pension.

Individuals could opt-out of the second tier through a system known as contracting out. Contracted out people paid a lower level of National Insurance, but had to build up a pension in a private pension scheme (such as a workplace pension).

Previous governments were keen to ensure that the SERPS lost through contracting out were suitably replaced and so placed conditions on the private pensions. One such condition was that for people contracted out prior to April 1997, the pension scheme had to ensure that a Guaranteed Minimum Pension (GMP) was paid in retirement.

Guaranteed Minimum Pensions were built up between April 1978 and April 1997

Previous governments placed rules on how the GMP was to be calculated and pension schemes have to abide by these rules.

How are GMPs increased?

One of the rules specific to Guaranteed Minimum Pensions was how they are increased each year when someone reaches Guaranteed Minimum Pension age (65 for men and 60 for women).

The increases applied are not exclusively paid by the private pension scheme. The legislation says that for GMPs built up before April 1988 the pension scheme does not have to pay any increases (i.e. a 0% increase). For GMPs built up between April 1988 and April

1997, pension schemes have to pay an increase in line with (CPI) inflation up to 3%. These two distinct elements are known as the pre-88 GMP and the post 88 GMP.

Previous governments have been keen to ensure however that these amounts do receive full inflation linked increases. As such there is a mechanism for ensuring that increases that are not applied to the GMP by the pension scheme are delivered elsewhere.

These increases are achieved by government by making adjustments to the Additional State Pension when it comes into payment.

Simplified Example
Paul has a Pre 88 GMP of £1,000pa and a post 88 GMP of £1,000pa as a result of being contracted out. Paul also had some contracted in service and receives an Additional State Pension (SERPS) of £1,000.

In a year were price inflation runs at 5%, Paul gets a 0% increase to his pre-88 GMP; a 3% increase to his post-88 GMP (£30). His SERPS are increased by 5% (£50) and then by a further £70, representing the respective £50 and £20 increases that were not applied to the pre- and post-88 GMPs.

In essence the state has funded the increases to GMP through State Pension increases.

What is Changing?
When the new State Pension is introduced, any new pensioners will no longer receive an Additional State Pension. This means that no adjustments will be made to offset the loss of increases on Guaranteed Minimum Pensions. So Paul (as above) would not get the £70 adjustment if he received State Pension under the new system.

Depending on future inflation levels and life expectancies, this could result in much lower retirement income for those with some Guaranteed Minimum Pension, particularly pre-88 GMP.

What has Government done to offset this loss?
Nothing directly, although Government believe that these losses will be offset by the ability to build up pension in the new State Pension system from April 2016, which will be subject to higher levels of increases through the Triple Lock (pension increases by the higher of 2.5%, CPI and wage inflation).

This may be the case for those who are some way from State Pension age and who can contribute sufficient years' of National Insurance. However, it will not apply to those who reach State Pension age soon after the new system is introduced.

What has Prospect done?
We have written to the Minister, to DWP and to the parliamentary scrutiny committee highlighting the issue and suggesting a mechanism through which this loss could potentially be offset by making adjustments to the Starting Amount (the amount of state pension built up when the new system is introduced). These representations can be seen at www.prospect.org.uk/statepensions .