EXPLANATORY MEMORANDUM TO THE SOCIAL SECURITY (RETIREMENT PENSIONS ETC.) (TRANSITIONAL PROVISIONS) REGULATIONS 2005

2005 No.469

1. This Explanatory Memorandum has been prepared by the Department for Work and Pensions and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Description

2.1 The Pensions Act 2004 introduces a new option of a lump sum payment for people who defer their entitlement to their State Pension or Shared Additional Pension for at least twelve months, as an alternative to an increased weekly pension (or "increments"). The Act also brings forward changes that were originally due to take effect in 2010 to increase the rate at which increments are calculated and remove the time limits for deferral.

2.2 These Regulations modify these provisions for people who have already started deferring their State Pension or Shared Additional Pension when these new provisions come into force on 6 April 2005, in order to:
(i) prescribe the period for which the lump sum is to be calculated;
(ii) allow lump sums to be calculated in a different way to that set out in the Pensions Act, where this would be beneficial to the claimant;
(iii) simplify the transition from the "old" to the "new" rate of increments; and
(iv) enable increments to be awarded for the pre- 6 April 2005 period where the normal "de minimis" rule would be breached as a consequence of a person choosing a lump sum for the period 6 April 2005 onwards.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 These Regulations modify Schedule 11 to the Pensions Act 2004 in relation to persons who are deferring their entitlement to State Pension or Shared Additional Pension as at 6 April 2005 and whose period of deferment began before that date ("transitional cases"). The draft Regulations were therefore referred to Parliamentary Counsel and the drafting incorporates their comments.

4. Legislative Background

4.1 Section 55 of, and Schedule 5 to, the Social Security Contributions and Benefits Act 1992 (c.4) (the "Benefits Act") allows for entitlement to the State Pension to be deferred and provides for how increments are to be calculated, Section 297 of, and Schedule 11 to, the Pensions Act 2004 (c.35) amends these provisions to give effect to the changes summarised in paragraph 2.1 above.

4.2 Shared Additional Pension was introduced by the Welfare Reform and Pensions Act 1999 (c.30). Shared Additional Pension is the pension to which a person becomes entitled by virtue of a pension-sharing order made in respect of the additional (earnings-related) State Pension. Such a pension is payable to the former spouse from State Pension age. Under section 55C of the Benefits Act, a person may defer entitlement to their Shared Additional Pension and accrue increments in broadly the same way as for the normal State Pension. The Pensions Act 2004 makes corresponding changes to the regime for deferment of Shared Additional Pension by substituting section 55C and introducing a new Schedule 5A to the Benefits Act, to allow for a choice between increments and a lump sum, and to increase the rate at which increments accrue.

4.3 The new provisions take effect from 6 April 2005. Paragraph 27 of Schedule 11 allows regulations to be made to modify the provisions of Schedule 11 in respect of persons who are already deferring entitlement to the State Pension or Shared Additional Pension at that date. This is the first use of this regulation-making power.

4.4 This Instrument is one of four sets of regulations to be passed by the negative resolution procedure that are required to underpin the new deferral arrangements with effect from April 2005. The other three instruments are:

(i) The Social Security (Deferral of Retirement Pensions) Regulations 2005;
(ii) The Social Security (Graduated Retirement Benefit) Regulations 2005; and
(iii) The Social Security (Claims and Payments) Amendment Regulations 2005.

5. Extent

5.1 This instrument applies to Great Britain. Equivalent provision will be made for Northern Ireland by statutory rules.

6. European Convention on Human Rights

6.1 The Minister of State for Pensions, Mr Malcolm Wicks, has made the following statement regarding Human Rights:

In my view, the provisions of the Social Security (Retirement Pensions etc.) (Transitional Provisions) Regulations 2005 are compatible with the Convention rights.

7. Policy background

7.1 People who defer their State Pension currently, whether by not claiming it on reaching State Pension age or by electing to stop claiming it, receive an increased pension when they finally claim. This increase is calculated according to a formula that entitles the person to an increment of 1/7% of his weekly pension rate for each "incremental period" (effectively a week) that he defers. No increase is payable if the total increments would amount to less than 1% of the weekly pension. Thus a person must defer for at least seven weeks before increments may be awarded. The same formula also applies to increments accrued by deferring a Shared Additional Pension.

7.2 Following the amendments made by the Pensions Act 2004, from April 2005, people who defer their entitlement to State Pension (or Shared Additional Pension) entitlement will have the choice of either a lump sum based on pension foregone plus interest, or increments calculated under a more generous formula. This new formula gives an increment of 1/5% of the weekly pension rate for each incremental period, effectively reducing the minimum period a person must defer in order to qualify for increments to five weeks under the 1% rule.

7.3 The choice of either a lump sum or increments will be available to those who defer entitlement for at least twelve months from 6 April 2005. Any period of deferment falling before that date will not count towards the qualifying period for the lump sum, but will entitle the person to increments at the pre-change rate.

7.4 As it is the intention that a person must normally choose either increments or a lump sum for any one period of deferment, these Regulations specify that for a transitional case where a person chooses the lump sum option, increments may only be awarded in respect of the part of the deferment period that falls before the first possible date from which a lump sum could be calculated.

7.5 These Regulations modify the application of the 1% rule for increments for two reasons. The first is to simplify the transition from a 7- to a 5- week minimum qualification period. Instead of a more complex calculation based on one of several different combinations of "before" and "after" incremental periods that would otherwise be required to satisfy the 1% condition, these Regulations would provide that the minimum qualification period is either 7 weeks, or, where a person has at least one incremental period to which the new rate would apply, 5 weeks. The effect of this is that a person who deferred for no more than 5 weeks could be entitled to increments amounting to

slightly less than 1%.

7.6 The second reason is to ensure that those who continue deferring to at least 6 April 2006 and choose a lump sum when they finally claim their pension do not lose out. If they began deferring their entitlement only shortly before 6 April 2005, they may not have accrued enough increments in the period prior to that date to fulfil the 1% rule. These Regulations provide that so long as the person has accrued at least one increment, it will be payable. This means that the increments accrued in the period prior to the date of change are awarded irrespective of the person's choice for the post-change period.

7.7 Lastly, these Regulations allow the lump sum to be calculated in a different way where this would result in a larger one-off payment than if it was calculated under the provisions of the Pensions Act. From 6 April 2005, the maximum period a person may backdate his claim for State Pension is being gradually extended from 3 to 12 months.[1] In some cases, a person who begins deferring his pension before that date and continues deferring for a further 12 months or longer may be entitled to a bigger one-off cash payment by opting for maximum backdating (ie a payment of straight arrears without interest) rather than a lump sum. This is because any increments accrued prior to 6 April 2005 will form part of the weekly pension from the date of claim. If the date of claim is backdated 12 months, the calculation of arrears will therefore comprise the normal weekly pension plus increments. Lump sums only accrue in respect of deferred entitlement i.e. the period for which a claim has *not* been made. Thus any increments accrued in the period of deferment before April 2005 do not form part of the persons' weekly pension until the date of claim, and consequently are not included in the calculation of the lump sum for the "post-change" part of the deferment period.

7.8 As an example, assume a person delays claiming a weekly pension of £100 for a total of 2 years, the first year falling before 6 April 2005. A payment of 12 months' backdated arrears would give him a cash payment of approximately £5,586 (comprising £100 plus £7.43 a week increments accrued at the pre-change rate for 52 weeks). However, a lump sum under normal rules (ie pension foregone plus interest) would give him approximately £5,380.[2]

7.9 To avoid the claimant having to work out which date he needs to claim from in order to maximise his one-off payment, these Regulations will allow the lump sum to be worked out as if it was a payment of backdated arrears.

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[1] cf. paragraph 4.4(iii) of this memo: regulations 3, 5 and 6 of The Social Security (Claims and Payments) Amendment Regulations 2005 refer.

[2] Illustrative rates only: these do not take account of changes in the lump sum interest rate or annual uprating of pension rates.

7.10 This provision is only required for transitional cases because it is only in such cases that a period of deferment will be split between increments and a lump sum. The point at which a lump sum overtakes a payment of arrears in terms of better-buy depends on a number of factors, including length of time pre- and post - 6 April 2005 that the person deferred, the amount of weekly pension and the interest rate applicable to the lump sum. However, in most cases, the lump sum calculation results in a higher amount for those who defer between 15 and 18 months beyond 6 April 2005. For post-transition cases, the lump sum will calculated over the full deferment period, as compared to a maximum of 12 months' backdating. For example, the lump sum for a person who deferred £100 a week for 18 months would be approximately £8,200 compared to £5,470 (comprising £100 per week plus £5.20 a week increments for 6 months).[3]

7.11 These Regulations have not been referred to the Social Security Advisory Committee as they are to be made within 6 months of the date on which the relevant provision of the Pensions Act 2004 came into force.

8. Impact

8.1 A Regulatory Impact assessment has not been prepared for this instrument as it has no impact on business, charities or voluntary bodies.

8.2 The public sector impact comprises administration and programme costs. It is not possible to disaggregate the cost of the proposals contained in these Regulations from the overall costs of the new deferral arrangements introduced by the Pensions Act 2004. The set-up costs are estimated at around £7 million, and include the cost of new technology to support the calculation of the lump sum option. It is anticipated that the changes will not result in the need for additional staff. The overall programme costs in the first three years ending March 2008 are estimated at £10m/£25m/£60, peaking at £115m in 2010/11 and declining in the long term.

9. Contact

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