

CONTRACTING OUT – YES OR NO?

In early 2004 the Financial Services Authority (FSA) told insurance companies to write to all of their clients who were using personal pensions to contract out of the 2nd tier of the State Pension Scheme. The purpose of the letter was to highlight the risks of contracting out and suggest an appropriate course of action. We have therefore produced this fact sheet to give you more information which we hope will help you in reaching your decision.

The State Pension Scheme

This consists of two components; there is the basic State Old Age Pension to which we are all entitled subject to a satisfactory National Insurance contribution record. In addition, with the exception of the self employed or those people who are members of their employer's final salary pension scheme, employees and their employers pay additional National Insurance contributions to build up an entitlement in the 2nd tier of the State Pension Scheme, formerly known as the State Earnings Related Pension Scheme (SERPS); now known as the State 2nd Pension (S2P).

The State Pension Scheme is operated on a pay as you go basis which means that current National Insurance contributions are being used to meet today's State Pension and other Social Security benefits. Today's workers are therefore relying on future generations paying into the N.I. fund to meet their State Pension promise.

The problem is, we are all living longer in retirement, we are drawing higher levels of State Pension benefits than ever before and with a falling birth rate and increased part time working fewer of us are paying full rate N.I. To put it another way, back in the mid 1970's, seven workers supported one pensioner. By the year 2050 that ratio is expected to reduce to two to one.

In an effort to reduce its long term liabilities, the Government introduced the concept of contracting out in July 1988.

How does it work?

Employees and their employers continue to pay the full rate National Insurance to the Contributions Agency who, once a year, rebate part of those N.I. contributions into a personal pension set up by the individual with their chosen insurance company. For each tax year that the individual is contracted out they will build up no entitlement to S2P although their basic State Pension entitlement is unaffected. This money is then invested by the insurance company for long term capital growth and at the point of drawing benefits this fund must be used to buy an annuity policy which will pay a pension to the individual for the rest of their life.

Whether or not that eventual pension is greater or lesser than what the 2nd tier of the State Pension Scheme would have provided if the individual had not contracted out will

depend upon investment growth in the policy up to the point of retirement and annuity rates at that point, neither of which can be guaranteed. Contracting out is therefore a risk and individuals may be better or worse off as a result. It is these risks that the FSA required insurance companies to remind their clients of.

Not surprisingly, the Government set the level of National Insurance Rebates at the lowest they thought they could get away with and it is difficult to make a case, in pure financial terms, for contracting out. Lower investment returns and falling annuity rates also add weight to the argument to contract back in.

As a result some insurance companies have written to their clients and said contract back in regardless of age whilst others have suggested “pivotal ages” from which point it is probably best to contract back in.

Therefore, in strict financial terms, we can make no case for contracting out and if that is your priority, you should remain or contract back in.

The N.I. rebate is also calculated as a percentage of pensionable earnings in the band between £5,044 p.a. and £33,540 p.a. (2006/07). If you earn less than £33,540 p.a. then your N.I. rebate is progressively lower, further favouring not contracting out.

The Emotional Argument

For some people the debate is not purely in financial terms. There are still tremendous strains on the State Pension Scheme and it is widely believed that the Government will have no option but to extend, at some point in the future, the scope of means tested benefits to include the second tier, and perhaps even the basic state old age pension as well. There is a very real prospect that those people who have made adequate provision for their retirement could be denied some of their State Pension if economic circumstances dictate. Of course, no political party has come out and said this, but the demographics make a convincing case.

Therefore, many people ignore the financial argument and continue to contract out in the knowledge that they are likely to be worse off than contracting back in, but in knowing that the monies built up in their personal pension cannot be denied them by means testing. They also believe that at retirement, the profit or loss from contracting in or out will represent an extremely thin slice of their overall retirement cake.

In summary, if we have to nail our colours to the mast, then our advice is to contract back in, but we recognise that other factors may play a part in your eventual decision. We hope this helps.